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China Market Perspectives

Shaping up the new financial market

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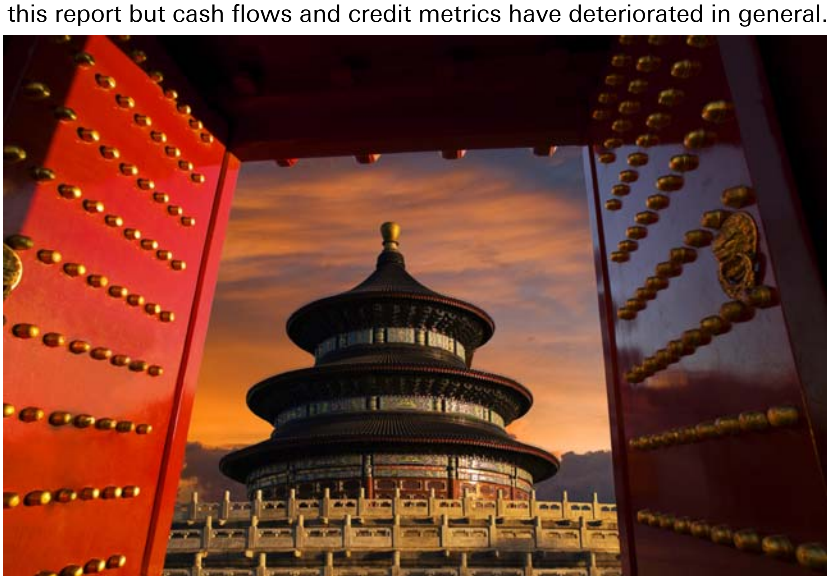
- We believe we are standing at the most exciting moment in China's economic and financial development history, a point at which comprehensive financial liberalization reforms will be pushed out to re-orient China's macro policy and financial regulation toward a financially open economy with fully convertible RMB. These reforms will shape China's new financial market, which has deeper market structure, stronger regulatory and legal infrastructure, and can efficiently mobilize savings and allocate financial resources domestically and increasingly globally. To help our readers form a sensible medium- to long-term investment strategy in China, we present our outlook of China's financial reforms and financial legislation.
- The government announced in March that it aims to make the RMB convertible in 2015. We believe this reform aims to help China's application to make the RMB an SDR basket currency.
- We revise our interest rate call and expect two further cuts in 2015. We reiterate our view that M2 growth should pick up in Q2 and rise to 14%yoy by the end of 2015.
- We see an extended market consolidation in equities in the near term on and we reiterate the key word for 2015 is the "R.R.R." (rate-cut and reform drive re-rating).
- We expect flush interbank liquidity and further policy easing to mitigate supply risk in Q2 and IRS/NDIRS curve will continue to bull steepen.
- We believe the RMB has fulfilled the necessary requirements to be added to the SDR basket.
- Generally speaking the tug of war between fundamentals vs technicals continues in our space. We discuss the more relevant sectors in detail in this report but cash flows and credit metrics have deteriorated in general.



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China Overview

- Key theme: Financial deepening reform will likely again take the center stage in China's structural reforms in 2015. Financial deepening reform focuses on five key areas of reforms – interest rate liberalization, exchange rate liberalization, capital account liberalization, domestic capital market deepening, and RMB internationalization. Moreover, reforming China's financial regulatory framework through establishing macro prudential policies, deregulation, and implementing the Rule of Law is vital in developing efficient and sound financial markets while safeguarding financial stability.
- Indeed, since mid-March (after the National People's Congress), we have seen new financial reforms being introduced or implemented at an accelerated pace. We view these new reforms as concrete steps forward for China to develop its financial market structure and transform its regulatory infrastructure.
- In the key theme article, we first review the recent financial liberalization polices and analyze their market impact. We believe the rolling-out of new reforms over the next 18 months will bring many positive surprises to the market. To help our readers form a sensible medium- to long-term investment strategy in China and prepare for the potential upcoming changes in the financial market and financial regulation, we present our outlook on financial liberalization reforms as well as financial legislation.
- Economic outlook: China has entered a significant policy easing cycle since end March. After the April 100bp RRR cut, the PBoC cut one-year benchmark rates by 25bp on 11 May and also lifted the ceiling of deposit rate to 1.5x of benchmark rate from 1.3x. We revise our interest rate call and expect two further cuts in 2015 – the next cut in June and another cut in Q3. We reiterate our view that M2 growth should pick up in Q2 and rise to 14%yoy by the end of 2015.
- Main risk: We maintain our view that growth may slow to 6.8% in Q2, and rebound to 7.0% in Q3 and 7.2% in Q4. Risks to our growth outlook in H2 are tilted to the downside.
- RMB may become convertible in 2015. The government announced in March that it aims to make the RMB convertible in 2015. We believe this reform aims to help China's application to make the RMB an SDR basket currency. The IMF review on SDR currencies will likely happen in October, hence we expect significant reforms in Q2 and Q3. We believe capital account liberalization may lead to net capital inflows in 2015. We see 70% probability that RMB will become an SDR currency by the end of 2016
- Equity strategy: We see an extended market consolidation in the near term on the back of 1) subtle policy tone change; 2) waning market liquidity inflows; and 3) unattractive valuations, while maintain a positive stance on Chinese equities in the medium term; we reiterate the key word for 2015 is the "R.R.R." (rate-cut and reform drive re-rating).
- Fixed income strategy: We expect interbank liquidity to remain flush and we maintain our forecast that 7D repo rate will stabilize at around 2%. We continue to see a steepening bias on the IRS/NDIRS curve and we keep our 5Y receiving NDIRS position with a revised target of 2.25% from 2.5%. We continue to recommend trading the CNH CCS curve in a range with a bullish bias and hold our receiving position in 1Y CNH CCS rates with a revised target to 2.6% from 2.9%. On the onshore credit market, we continue to expect the weaker credit to underperform and recommend asset allocation in the liquid high grade names.

- Foreign exchange strategy: In recent weeks, Chinese policymakers have sent very strong signals regarding their desire to have the RMB added to the SDR basket. From an economic standpoint, we believe the RMB has fulfilled the necessary requirements – it is (1) widely used and (2) widely traded. Our economist estimates only a 40% probability of RMB inclusion with its full weight (which we estimate to be around 8%) this year. But we think a compromise could be to include RMB in the basket but at a smaller weight, or to pre-commit to including the RMB in the basket when hedging instruments are sufficiently developed. This should further encourage China to forge ahead with reforms and address some of the concerns we discuss below. Regardless of the outcome, we continue to expect China to push its reform agenda as we believe this initiative will encourage (1) further accumulation of RMB assets by global investors, and (2) more reforms within the domestic financial system.
- Credit strategy: We look at the fundamentals for Chinese corporates and banks in detail in this edition post the just concluded FY14 results season. Generally speaking the tug of war between fundamentals vs technicals continues in our space. While fundamentals are still deteriorating technicals remain firm. The latest earnings season provided enough insights into the weakening fundamentals and we can say that things are worsening in China. We discuss the more relevant sectors in detail in this report but cash flows and credit metrics have deteriorated in general. The silver lining is that management are focused on balance sheet and cash preservation with raising the odd equity.
- Offshore RMB market: Analyzing the CNH CCS market: The CNH cross currency swap (CCS) market has developed over time and has now evolved into one of the most actively traded offshore RMB derivative curves. In this report, we present our analysis of this market to help you understand the balances of flows, factors that drive such flows, and how to capture investment opportunities to serve your business and investment needs in the RMB market. We start by looking at fundamental variables in CNH CCS pricing, then we identify and analyze the five primary types of flows in the CNH CCS market. We discuss the recent flow dynamics and explain our rationale for retaining a bullish view on CNH CCS rates. We recommend receiving 1Y CNH CCS at 3.6% with a revised target of 2.6%, down from 2.9% following the interest rate cut on 11 May.
- Offshore RMB policy update: On the policy front, the main theme since the start of this year has been China continuing to refine the offshore RMB clearing infrastructure and steadily expand the RMB QFII scheme globally.
- Recent developments in Taiwan's Formosa bond market. RMB bond issuance in Taiwan's Formosa bond market surged this year thanks to the relaxation of insurers' investment restrictions. We see three key market implications: (a) RMB Formosa bonds account for a rising share of the offshore RMB bond market; (b) RMB Formosa bonds have extended the duration of the offshore RMB bond yield term structure from the 3Y tenor to the 30Y tenor; (c) it improves trading activity at the long end of the CNH CCS curve. While we expect demand from Taiwan insurers to remain supportive for the RMB Formosa bond market, the recent rally in the CNH CCS curve has narrowed the potential cost savings for RMB swap-based borrowers. This suggests that RMB Formosa bond issuance is more likely to be driven by RMB financing (borrowers with real RMB cash demand) in the next few months.
- Q2 supply outlook. We forecast Q2 net supply of offshore RMB bonds and CDs at RMB90bn. We expect both IG corporate names and sovereign/quasi sovereign names to outperform the high yield sector.

- Offshore RMB deposit base update: We maintain our forecast that the offshore RMB deposit pool will grow 30% YoY to RMB3.25trn by the end of 2015, boosted by RMB investment and diversification demand from corporates, institutions, and foreign central banks.
- Q1 RMB settlement rose to 27% of China's global trade, above our forecast of 25% for the full year 2015. We expect RMB investment settlement to grow strongly going forward as China opens up its domestic capital market and relaxes capital account control. We expect the RMB investment settlement share to grow towards 20% of total RMB settlement volume by the end of 2015.
- Stable offshore RMB market turnover in Q1 suggests that the growth in RMB cross trade and investment settlement volume has been offset by a reduction in offshore RMB capital market investment activities

Key theme: Shaping up the new financial market

Introduction

2015 is the second year after the third plenum for China to implement comprehensive economic and structural reforms and the fifth year for China to complete its 12th five year. In 2014, China made significant progress in liberalizing financial markets – doubling the USDCNY spot FX trading band, widening the deposit rate ceiling and simplifying policy rate term structure, launching the Hong Kong – Shanghai Stock Connect Program, and passing the New Budget Law, to name a few.

Financial deepening reform will again take the center stage in China's structural reforms in 2015. Financial deepening reform focuses on five key areas of reforms – interest rate liberalization, exchange rate liberalization, capital account liberalization, domestic capital market deepening, and RMB internationalization. Moreover, reforming China's financial regulatory framework through establishing macro prudential policies, deregulation, and implementing the Rule of Law is vital in developing efficient and sound financial markets while safeguarding financial stability.

Indeed, since mid-March (after the National People's Congress), we have seen new financial reforms being introduced or implemented at an accelerated pace. We view these new reforms as concrete steps forward for China to develop its financial market structure and transform its regulatory infrastructure.

In the key theme article, we first review the recent financial liberalization polices and analyze their market impact. We believe the rolling-out of new reforms over the next 18 months will bring many positive surprises to the market. To help our readers form a sensible medium- to long-term investment strategy in China and prepare for the potential upcoming changes in the financial market and financial regulation, we present our outlook on financial liberalization reforms as well as financial legislation.

Review of recent financial reforms

Interest rate liberalization

- Widening deposit rate ceiling

From November 2014 to May 11, 2015, the PBoC widened the ceiling of domestic deposit rates three times from 1.1x policy deposit rates to 1.5x policy deposit rates. With deposit insurance having taken effect since May 1, we have seen increasing deposit pricing differentiation by commercial banks – large banks have kept the deposit rate ceiling at around 1.2x, while medium to smaller banks have left their deposit rate at between 1.3x and 1.5x the policy deposit rates. We think the new ceiling gives sufficient room for banks to enhance their deposit pricing capacity.

- Deposit insurance scheme took effect May 1

On March 31, the State Council issued the Deposit Insurance Regulation (Decree of the State Council, No. 660). The regulation was passed on October 29, 2014, and took effect on May 1, 2015. We see the following four key market implications of the deposit insurance scheme.
(a). Establishing explicit deposit guarantee: The introduction of the deposit insurance system in China marks the transition from implicit deposit guarantees (by the government) to explicit deposit guarantees with clear specifications on the objectives; the operating principals and procedures; and

the responsibilities and obligations of participating financial institutions, the deposit insurance fund, depositors, and regulators of the deposit insurance system. With this, China joins 113 jurisdictions (as of January 2014) globally that have instituted explicit deposit insurance. We believe establishing an explicit deposit insurance scheme is China's most important financial reform to construct a financial system safety net and promote financial system stability.

(b). Preparing for fully liberalized deposit rates: The deposit insurance scheme is another major policy milestone in China's interest rate liberalization reform. Since July 2013, China has pushed interest rate reforms, with the removal of the lending rate control in July 2013, the launch of the interbank CD market in December 2013, and the widening of the deposit rate ceiling to 1.3x the policy deposit rate in March 2015. In the meantime, the financial services sector is gradually opening up to private capital (five privately owned banks were approved in 2014, and a few more will likely be approved this year) and smaller financial institutions to meet financing demand by the private (non-SOE) sector, particularly small- and medium-size enterprises. As interest rates are more liberalized, it is urgently necessary to build a more competitive banking sector by leveling the playing field such that small- and medium-size banks as well as privately owned banks can compete with large commercial banks on deposit-taking, without jeopardizing the financing system's stability. With an explicit deposit insurance system, we believe China is ready to fully liberalize deposit rates, and we think this is more likely in H2 this year. Furthermore, improving net interest margin conditions for smaller and privately owned banks will improve lending facilitation to SME borrowers to support economic growth.

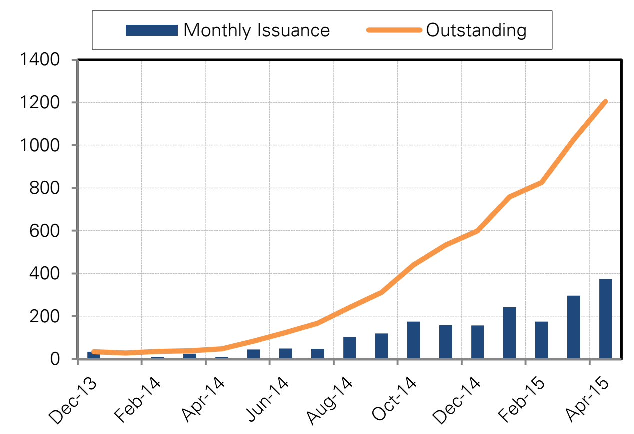
(c). Strengthening the trend of price differentiation among deposits and other money market instruments and reducing volatilities in money market rates: As deposit insurance does not cover Wealth Management Products (WMP) or other money market funds/products (such as Yu'er Bao) and interbank deposits, we expect the pricing of deposits, WMPs, and money market funds to be increasingly differentiated to reflect the risk-reward profiles associated with the various deposit-substituting investments. The pricing impact is much less on large commercial banks than on medium- to small-size banks, which will see a somewhat widening gap between interest rates on deposits covered by deposit insurance and interest rates on WMPs. To the extent that deposit insurance will improve the stability in the deposit base at the medium- to small-size banks, it will on the margin reduce money market volatilities (lowering the volatility risk premium on the Repo IRS curve by 2-5bps, in our view), as smaller banks' funding demand via the interbank funding market is likely to be more stable.

(d). Re-pricing credit risk to support financial deepening in the domestic capital market: Establishing an explicit deposit insurance system has a profound impact on the credit risk pricing in the domestic financial market over the medium to long term. First, removing an implicit deposit guarantee means that credit defaults will be allowed to take place on a wide range of financial products going forward, and losses to principal investment are inevitable; second, it is an integral step toward establishing a market-based exit strategy of financial institutions, which is necessary in driving efficient capital allocation in the financial market. Such considerations aim at supporting the deepening and healthy development of the domestic capital market over the medium to long term but do not necessarily imply any near-term risk. We think investment products in the shadow banking market, trust products, and other types of high-yield products are vulnerable to such credit risk re-pricing. For 2015, we maintain our expectation that China will continue to allow credit events to occur, provided such events do not pose systemic threats, and to improve transparency and efficiency of credit risk pricing, as well as to explore market-based approaches in dealing with any credit events. Having said that, we believe the tightening in regulation for the shadow banking market since 2013, the closure of the LGFV debt market this year (LGFVs can no longer issue debt), and the recent local government debt swap has reduced credit risks in the financial system.

- Expanding interbank CD market

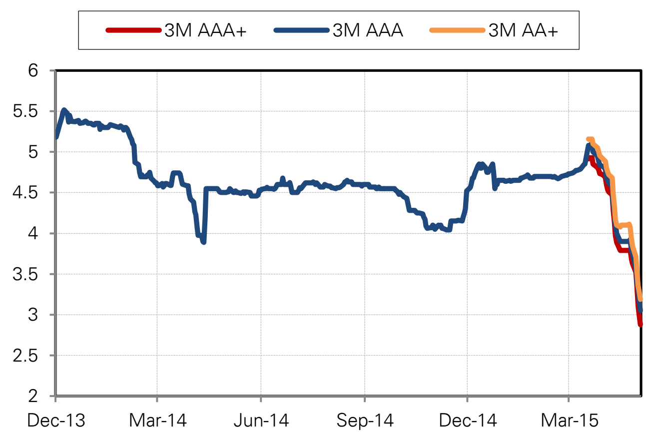
Interbank CDs are wholesale financing instruments by commercial banks, and the interbank CD market helps commercial banks' deposit rate pricing, reduces the duration risk of their asset and liabilities, and drives onshore money market growth. The program was launched in December 2013 with 10 pilot commercial banks eligible to issue interbank CDs, and the program was expanded to more deposit-taking institutions in May 2014. Since December 2013, about RMB2.2trn of interbank CDs have been issued, and the size of the market was RMB1.2trn by the end of April 2015, approximately 3.2% of China's domestic fixed income market. Issuance of interbank CDs is based on registration with the PBoC with an annual quota, and for 2015, banks have announced plans to issue about RMB2.85trn. Currently, the issuing yield of 3M interbank CDs by AAA+, AAA, and AA+ rated banks are 2.87%, 3.05%, and 3.19%, respectively, vs. 3M Shibor at 3.32% on May 15.

Figure 1: Interbank CD market growth (RMB bn)



Source: Deutsche Bank, WIND

Figure 2: Interbank CDs issuing yield



Source: Deutsche Bank, WIND

Exchange rate liberalization

■ FX conversion deregulation

On April 7, the SAFE, the FX regulator, announced a Notice on reforming the FX conversion management by FDI corporations (Document No. [2015] 19). The new regulation will take effect on June 1. The introduction of the new FX regulation follows the same regulation applied in a pilot scheme that was launched in August 2014 in the SHFTZ and other selected cities/provinces. (Document No. [2014] 36).

The new regulation allows corporations that make foreign direct investment in China to convert their equity capital investment freely, and SAFE will adopt a "negative list" to manage such FX conversion activities. It will facilitate FDI corporations' domestic equity investment. Commercial banks will be responsible for the verification of the authenticities of such activities, and SAFE will review activities retrospectively and punish any violations when necessary.

We see three key market implications:

(a). Improving efficiency of FX risk management. Prior to this change, FX conversion by FDI corporations had to be triggered by the need to make payments. Now these corporations can convert their equity capital investment into RMB anytime based on their business operating needs. This will help FDI corporations to better manage their FX risks.

(b). Improving capital account convertibility. It is an important measure to liberalize FX regulation and move toward capital account convertibility.

(c). Limited near-term impact on the FX market. Total utilized FDI in 2014 was about RMB120bn, up by 1.7% YoY. While the pace of FDI growth has decelerated over the past two years, we expect monthly FDI inflow to stabilize at around USD8-10bn per month in 2015. We do not expect the new regulation to cause a surge of FX conversion into RMB in the near term because corporations' FX hedging activities are highly correlated with RMB valuation. Given the balance of risks in the market remains biased toward USD strengthening in the near term and RMB continuing to demonstrate two-way volatility, FDI corporations' demand for RMB is likely to be driven by their actual spending needs.

- FX management deregulation

a. Simplifying FX management: On March 19 and May 8, China's FX regulator, the SAFE, abolished more than 50 FX management rules/documents to simplify FX regulation, and this is in addition to the 700 FX management rules/documents abolished since 2009. The purpose is to (a) reduce redundancy/over-regulation on financial institutions and on capital account transactions in order to facilitate freer capital flows under direct financing, external guarantee, capital market access, and FX conversion; and (b) to strengthen the monitoring and data collection of cross-border capital flows to cope with more efficient data compilation following the IT system integration and upgrades.

b. Implementing new BoP accounting and reporting standard: Another major development in FX management is that, starting from 2015, China implemented the sixth edition of its Balance of Payments and International Investment Position Manual (BPM6, which was released in 2009) in its BoP accounting and reporting. Also, from 2015, the SAFE added data reporting of China's monthly merchandize trades and service trades volumes to comply with the new BPM6 accounting standard. Adopting the new global standard in BoP reporting improves the transparency and quality of China's BoP data compilation, which also help regulators monitor cross-border flows more effectively.

c. Experimenting with macro prudential policy framework. In our view, the most important FX deregulation reform this year is the launch of an external debt macro prudential management pilot program.

In April 2015, the SAFE approved three pilot zones to experiment with external debt macro prudential measures reform. There are two key highlights of the reform:

(a). Allowing Chinese corporations to borrow external debt (in RMB or foreign currency) with a quota of 2x the net assets of the respective corporations (net assets are per the audited financial statement as of the last financial year), and total external debt may not exceed 75% of corporations' total assets; and

(b). Abolishing the requirement that proceeds from external debt borrowing should not be converted into RMB, thus granting Chinese companies "national treatment" as foreign companies that invest in China.

In our view, the purpose of experimenting with external debt macro prudential measures is: (a) to broaden financing channels for Chinese companies; b) to allow companies to optimize financing strategy by accessing external financing; and (c) to prepare for establishing formal macro prudential measures to manage external debt, as part of the capital account convertibility reform.

The pilot program starts with high-tech companies in three pilot zones: Beijing Zhongguancun Science Park, Zhangjiagang Free Trade Zone in Jiangsu province, and Shenzhen Qianhai Free Trade Zone. Several companies have already secured external financing under the pilot program.

- FX reserve diversification

Setting up the Silk Road Fund

The Silk Road Fund was set up on December 29 last year. According to the PBoC, this is a private equity fund seeking long-term investment, and China invests USD40bn in the fund. The fund will primarily provide financing to infrastructure construction, resource exploration, industrial and financial cooperation, and other relevant projects along with the Belt and Road Initiative and the 21st Century Silk Road by the Sea initiatives.

The fund intends to make early-stage equity investment in long-term projects. Its investment mandate is similar to that of the IFC and the African Development Fund. The fund has completed its initial fundraising, with USD10bn in capital from the SAFE, USD1.5bn each from CIC and Export & Import Bank of China, and USD500mn from China Development Bank. The Silk Road Fund made its first investment on April 20 in Pakistan.

We take the launch of the Silk Road Fund as part of China's investment and financing reform as being for the purpose of FX reserve diversification. First, China's FX reserve has largely been managed by the official sector, and asset allocation has mostly been in the fixed income market, with equity investment mostly in listed stocks. The Silk Road Fund diversifies some official reserves into a new PE asset class for long-term capital appreciation as a way to boost the overall return of China's FX reserves. Secondly, it will provide financing services to China corporations for outbound investment and will support economic growth in emerging economies in Central Asia and South East Asia.

Banking sector reform

- Policy banks reform

On April 12, the PBoC announced that the State Council has approved the reform plan for three policy banks – China Development Bank, Export and Important Bank of China, and Agriculture Development Bank of China. According to the plan, two main reforms for policy banks are:

(a). Differentiated core business of policy banks: Prior to this, the China Development Bank reform plan in 2008 was to reform the policy bank into a commercial bank. Under the new reform plan, China Development Bank will remain as a policy bank and focus on long-term financing to support economic development projects; such business positioning is to support the One Belt One Road regional growth and development plan. The core business of AGDB and the EXIM bank will be to support macro growth policy implementation in the agriculture sector and global trades.

(b). Establishing capital adequacy requirements for policy banks: Although the key function of policy banks is to facilitate lending to support macroeconomic development initiatives, in practice, banking regulators adopt the same approach in managing loan/asset risks and the same risk weighting categorization for asset valuation as those applied to commercial banks; however, the capital adequacy requirement for policy banks is less stringent in implementation than for commercial banks. The new reform plan strengthens or establishes the capital adequacy requirement for policy banks (currently, the regulatory requirement for CAR for large commercial banks is 11.5%, and that for medium- to smaller-size banks is 1% lower), which should improve operating efficiency and risk control of policy banks. Considering the operating aspect of macro policy implementation by policy banks, we think adopting CAR that is applicable to the medium to smaller banks, i.e. CAR at 10.5%, is more realistic rather than a much stricter CAR requirement for large banks at 11.5%.

(c). Capital injection: Because all three policy banks currently do not meet the capital adequacy requirement, the next step is for the government to boost the capital base for policy banks by direct capital injection. According to China

Development Bank's 2014 financial statement, CAR was 9.06%, and Tier 1 capital ratio was 6.77% by the end of 2014. We think CARs at the Export and Import bank of China and Agriculture Development Bank of China would be lower, and we estimate that, for their CARs to reach 10.5%, each bank would need on average about USD25-35bn capital injection to be completed later this year.

Capital account liberalization

In 2015, China continues to liberalize two-way flows under the capital account. We highlight two recent developments:

- RMB QFII scheme expansion

In 2015, China continues to relax control over foreigners' access to domestic capital markets. The RMB QFII scheme has expanded to Switzerland and Luxembourg, bringing the total number of jurisdictions with RQFII access to 12, with a total announced quota of RMB870bn. By the end of April, an approximate RMB363.7bn RMB QFII quota had been granted to 121 foreign institutional investors, in addition to the onshore direct interbank bond market access quota of approximately RMB1,200bn, of which about 50% is granted to foreign central banks and sovereign wealth funds. Moreover, of the USD73.6bn QFII quota granted to foreign institutions, some of the funds have been invested in the onshore fixed income market. By the end of March, foreign investors held about RMB713bn of domestic bonds and RMB601bn of domestic equities.

- Allowing public securities investment funds to participate in the Stock Connect program.

On March 27, CSRC issued "Guidance of public securities investment funds to participate in the Stock Connect program", which specified that, effective immediately, new securities investment funds can trade the Hong Kong-listed stocks under the Shanghai – Hong Kong Stock Connect program, provided such activities have been disclosed in the terms of such funds' investment contracts, and QDII licenses are no longer required. Existing securities funds after obtaining approval by fund investors to revise their contract terms (to invest in Hong Kong stocks) can also participate in the Stock Connect without QDII licenses.

The Guidance relaxed domestic public funds' outbound capital market flows to the Hong Kong market (Hong Kong Stock Exchange) by lifting the QDII licensing and QDII quota requirement. It simplifies the investment regulation for public investment funds to participate in the Stock Connect program by removing the duplication of quota controls (both QDII and Stock Connect quotas), as such investment will now be regulated by the Southbound trading quota (currently at RMB250bn). It will boost Mainland institutional investors' participation in the Hong Kong market. According to CSRC, by the end of Q1 2015, there were a total of 2,027 public funds with total asset size of RMB5.24trn.

Developing domestic capital markets

Financial deepening requires the development of a comprehensive financial market structure that allows efficient market-based capital resource allocation. In this aspect, China has focused on (a) developing new products and new marketplaces; and (b) relaxing market access by economic agents such as corporations, financial institutions, and investors. We highlight four recent reforms:

- Municipal bond market was formally launched in April

In addressing local government debt risk, in 2015, one of the main investment and financing reforms by the Ministry of Finance is to manage local government debt risk by:
(a). Promoting direct financing (market-based and transparent way of financing) for local governments by formally launching the municipal bond program;
(b). Restructuring/cleaning up outstanding local government debt by rolling over existing local government debt (mostly bank loans) into municipal bonds through local government debt swaps, and closing any form of shadow financing by local governments; and
(c). Allowing private capital to invest in public projects by promoting PPP-based (private and public partnership) financing via corporate bond issuance: The government is keen to adopt the private and public partnership business model to increase public goods/services provision in the transportation, environmental protection, healthcare, and elderly sectors.

The Ministry of Finance has taken a few steps to launch the municipal bond market:
(a). Laying out the legal/regulatory/budgetary framework governing the municipal bond market by issuing three key regulations that formalize the municipal bond program;
(b). Announcing the RMB 1trn local debt swap and RMB600bn net municipal bond financing plan (RMB500bn GO bonds and RMb100bn SP bonds); summing these up, we expect RMB1.6trn of municipal bond gross supply in 2015, although net supply is much lower at only RMB600bn; and
(c). Managing the municipal bond supply risk by allowing for private placement of municipal bonds. Meanwhile, to support demand and improve liquidity for municipal bonds, the PBoC added municipal bonds as eligible collateral for its various targeted liquidity facilities and domestic long-term investors (Social Security Fund, Residential Housing Provident Fund are allowed to invest in municipal bonds with higher investment limits; discussed in the next bullet point).
Jiangsu province announced its RMB52.2bn GO bond issuance plan with an average life of 6.2 years to be auctioned on May 18.

We believe the launch of the formal municipal bond program is a major milestone both in China's fiscal reform and in China's financial market reform. It not only improves local governments' fiscal responsibility and transparency, but it also develops a new asset class in the domestic capital market. In the next three years, we expect up to RMB3trn of municipal bond issuance as a result of local government debt swaps, and we forecast an additional RMB4trn regular market-based issuance over the next five years, bringing the total size of China's municipal bond market to RMB7trn by 2019.

- Broadening long-term institutional investors' access to the domestic capital market

Relaxing market access by social security funds.

In the regular meeting on April 1, the State Council decided to expand the investment scope of social security funds. Specifically, it decided on the following measures:

(a). Expanding the bond investment scope of the Social Security Fund to include municipal bonds and increasing the investment limit of corporate bonds and municipal bonds from 10% to 20% of the asset size;

(b). Expanding the direct equity investment scope from shares of SOE restructure or SOE reform projects to include SOE and subsidiaries of SOE, as well as top-ranked local SOEs and local privately owned enterprises;

(c). Increasing the trust loan investment limit from 5% to 10% of total asset size and taking a more active role in supporting public housing projects and urban infrastructure projects; and

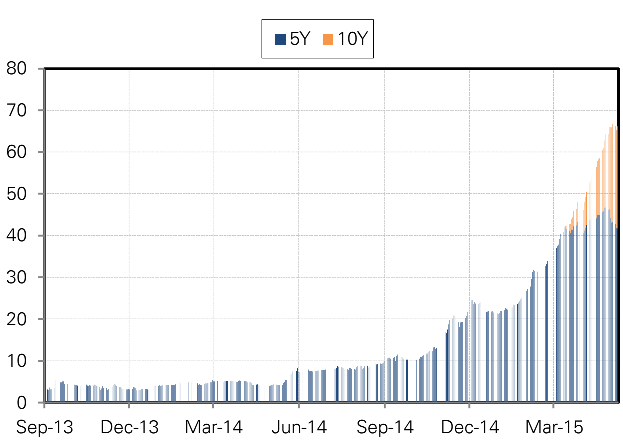
(d). Allowing the Social Security Fund to invest in interbank CDs in the primary market.

The relaxation of investment restriction of the Social Security Fund is designed both to diversify risks and to seek better long-term investment returns. It not only provides long-term financing to public housing and infrastructure projects, but it also boosts the demand technicals in the domestic capital market both to support SOE reform as well as the development of municipal bonds and PPP-based corporate bond issuance. We estimate that, based on the current size of the Social Security Fund of RMB1.5trn, this would potentially bring an additional RMB150bn in investment demand (up to RMB300bn based on the total AUM of the Social Security Fund of RMB1,529bn by the end of 2014) to corporate and municipal bond markets and RMB75bn to the trust loan market. Such a shift in asset allocation is likely to come at the expense of bank deposits and central government bonds investment. Furthermore, the Social Security Fund joins other institutional investors such as commercial banks in the interbank CD market.

- 10Y CGB futures contracts were listed in March

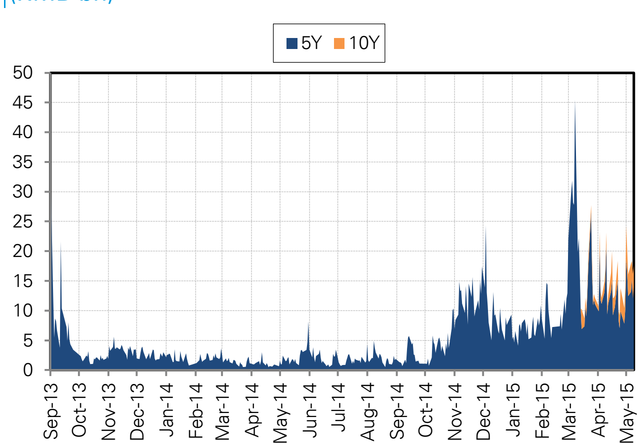
On March 20, 2015, China Financial Futures Exchange listed the 10Y CGB bond futures contract. China re-launched the bond futures market in September 2013 with the introduction of the 5Y CGB future contract). We believe this is an important reform in the financial derivatives market in that:
(a). The 10Y contracts extend the bond futures yield curve term structure; and
(b) The contracts meet interest rate hedging demand by long-term fixed income investors. Because the 10Y CGB is the most important benchmark of the long-term risk-free rate in China and the most liquid tenor, given the lack of effective long-term interest rate hedging tools in the derivative market (IRS curve is only liquid up to the 5Y tenor), the 10Y CGB futures can potentially meet significant market demand for long-term interest rate hedging.
Since H2 2014, the CGB futures market has become more active, with open interests of the 5Y contracts having more than tripled and 10Y open interests quickly rising to more than 50% of that of the 5Y contract. Average daily turnover of the 5Y contract rose from RMb4bn to RMB12bn, and the daily turnover of the 10Y contract is now at RMB4bn almost two months after it was listed.

Figure 3: Open interests of bond futures contracts (thousands of contracts)



Source: Deutsche Bank, CEIC

Figure 4: Daily turnover of bond futures contracts (RMB bn)



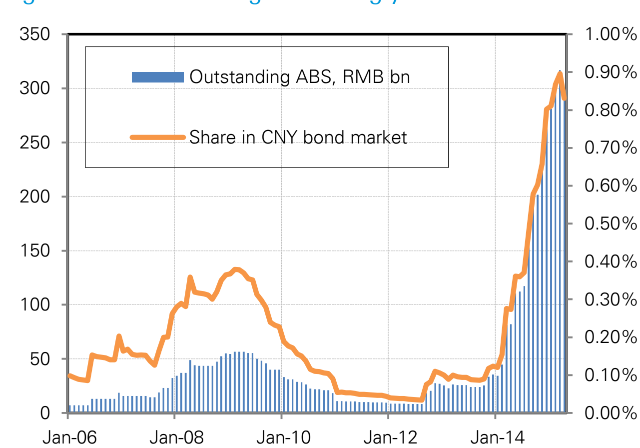
Source: Deutsche Bank, CEIC

- Relaxing ABS issuance control by establishing registration process by the CSRC and PBoC

China's ABS market was born in 2005, and 11 domestic financial institutions issued 17 ABS securities with a total funding size of RMB66.78bn during 2005-2008. The market was shut down after the global financial crisis and resumed in 2011. Following the State Council's decision to expand the pilot program of asset-backed securitization (ABS) in August 2013, the ABS market took off with about RMB330bn of new issuance in 2014. By the end of April, there was RMB75bn in ABS issuance, with the size of ABS market reaching RMB300bn, about 0.85% of China's domestic fixed income market.
We expect the ABS market to expand rapidly going forward thanks to two recent reforms by the CSRC and the PBoC to relax ABS issuance control.
In November 2014, the CSRC issued the "Notice about ABS record registration process" (Doc # 1092), allowing financial institutions that have received licenses to conduct ABS business to register their ABS issuance plan with CSRC. During the registration process, the CSRC and other regulators will only evaluate the legitimacy of the issuing institutions but will no longer inspect the underlying asset quality as they did in the past. While ABS issuance will no longer require CSRC approvals, the CSRC tightened the requirement of information disclosure by all parties involved in the ABS issuance.
In April 2015, PBoC issued document no. 7 to simplify the control of ABS issuance. Similarly, the PBoC established an ABS registration process for institutions that (i) have received licenses for ABS business; (ii) have issued ABS; and (iii) have complied with the information disclosure requirements. Such institutions can simply file for ABS issuance registration with the PBoC without any additional administrative approval. All relevant parties (financial institutions, credit rating agencies, etc.) involved in the ABS issuance are required to fully disclose asset quality and product information, etc., to investors.

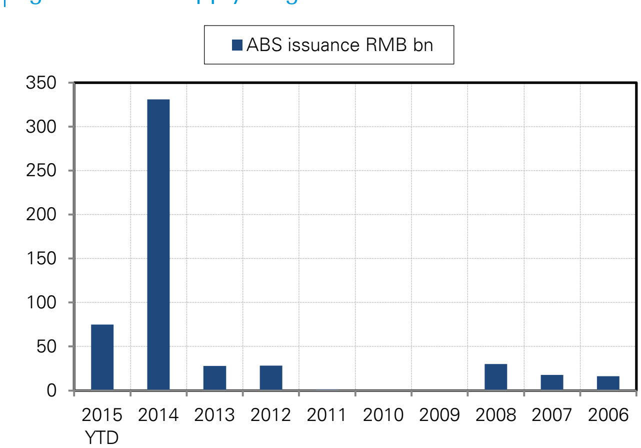
China's ABS market is still in its infancy, but the pace of growth over the past 18 months suggests significant growth potential, especially considering the large size of commercial banks' loan portfolio (about RMB80trn), which includes high-quality assets both from consumer credit loans and mortgage loans. On the other hand, the ABS market as an emerging asset class potentially will attract strong investment interest from domestic and global investors. Looking ahead, with further developments on improving the transparency of asset valuation, standardization of product structure, risk disclosure, and investor protection, we expect the ABS market (including the MBS market) to grow strongly in the coming years, and we forecast the size of the ABS market to rise from RMB300bn currently to RMB5trn over the next five years.

Figure 5: ABS market grew strongly from 2014



Source: Deutsche Bank, CEIC

Figure 6: ABS supply surged since 2014



Source: Deutsche Bank, WIND

Outlook of key financial reforms

We believe China will keep rolling out financial reform measures at an accelerated pace later this year and in 2016. Specifically, we expect the following reforms to take place in the coming 18 months.

Interest rate reform

We expect the PBoC to liberalize deposit rates toward the end of 2015, completing the interest rate liberalization reform started from July 2013. Meanwhile, monetary policy reform during 2015-2016 will focus on three key issues:

(a) Developing a short-term policy rate target, either the overnight rate or the 7D rate. Currently, the PBoC is effectively operating an interest rate corridor via OMO rates and SLFs, and we believe it is monitoring the money market rates closely, although we feel a more rigid and transparent market-based framework is yet to be established;

(b) Improving monetary policy transmission by further developing the money market and CGB market in order to establish a more liquid, reliable risk-free yield curve terms structure;

(c) Refining open-market operations by offering more frequent (daily) open-market operations and by adding intraday liquidity facility to the interbank market. This is a very critical reform, in our view, because as RMB is becoming increasingly convertible and more internationalized, cross-border RMB flows will be more volatile, which will translate into highly volatile short-term interest rates intraday. Currently, there is no intraday liquidity facility provided by the PBoC in the onshore interbank market, and in the offshore RMB market, the intraday liquidity facility provided by HKMA is not used actively; this has left the market rather desperate in facilitating liquidity demand on its own, which has been the source of liquidity squeezes. Availability of an intraday liquidity window from the central bank is the best way to manage the stability of RMB short-term interest rates, which is the key in efficient monetary policy transmission.

We also expect China to expand the Certificate of Deposit market to corporate and retail investors. Over the next five years, we forecast interbank CDs financing to grow tenfold to RMB10-12trn.

Exchange rate/FX regulation reform

China will continue to increase the flexibility of RMB exchange rates, and we expect the intraday spot band of USDCNY to be expanded to +/-3% in H1 2016.

With capital accounts opening up and interest rates fully liberalized, we believe the most important task in China's FX regulation reform in the next one to two years is to make the transition from a quantity-/quota-based framework to a market-based and priced-based framework by establishing macro prudential measures. We expect the following reforms:

(a) Introducing price measures to control short-term capital flows such as financial transaction fees (similar to Tobix Tax) and paying zero interest rates on required reserves from short-term deposits;

(b) Expanding the external debt macro prudential measures (discussed in the previous session) from the three pilot zones to nationwide; managing external debt based on corporates' assets and operating performance rather than by quotas;

(c) Opening up the onshore FX market to foreign investors and offshore market players and allowing more FX derivatives to be traded in the market; and

(d) Continuing to deregulate FX management through reducing administrative approvals and implementing "negative list" management.

Capital account liberalization

We believe China aims to make RMB basically convertible by the end of this year. For detailed analysis on RMB convertibility, please refer to "RMB will be convertible in 2015" by our chief China economist Zhiwei Zhang.

We expect three key policies to take effect this year:

- Shenzhen – Hong Kong Stock Connect program will be launched in Q3 this year. This is the second step in liberalizing two-way capital flows via regional stock exchange integration, following the launch of the Hong Kong – Shanghai Stock Connect in November last year.
- Significantly expanding foreigners' access/investment quota into domestic fixed income market via QFII scheme, RMB QFII scheme, and direct interbank bond market access. We expect foreigners' holding of domestic capital market (both fixed income and equity market) investments to rise from 3% currently to 10% over the next five years. We expect investment quota controls to be removed completely over the next five years.
- Introducing QDII program for domestic individual investors. The QDII 2 has been under the pilot program in Guangdong province since mid-2013, with a ceiling for individual FX conversion of RMB20mn. We expect this program to be expanded nationwide later this year, which also effectively will lift the current individual FX conversion limit of RMB500k.
- Liberalization reforms in the four free-trade zones: In April 2015, the State Council released the development plan for the four free-trade zones in Guandong, Tianjin, Fujian, and Shanghai. The free-trade zones will continue to experiment with capital account convertibility, promoting free trade, and we expect progress to be made primarily in liberalizing cross-border financing for corporations this year.
- Relaxing interbank financing access of offshore financial institutions: Permitting offshore financial institutions' access to domestic interbank market will help offshore banks better manage offshore RMB liquidity and improve the transmission of onshore monetary policy in the offshore RMB market.
- Allowing more foreign corporations to list equities domestically or issue panda bonds. China will gradually open up its domestic capital market to global corporations for financing; however, we believe this may take another one to two years, considering the practical constraints with China's accounting standard and listing requirements.

Developing domestic capital market

- IPO registration reform

We believe the priority in China's capital market reform this year is IPO registration reform. With strong growth in demand for capital market financing in recent years, the administrative approval control on IPOs has become increasingly inadequate in supporting healthy growth of the equity market. Establishing an IPO registration process is important both to reduce administrative intervention in the IPO market and to shift the focus of IPO regulation from ex-ante control to strengthen ex-post regulation. IPO approval will be shifted to the Stock Exchanges, which follow standardized disclosure requirements. The IPO registration reform will fundamentally change the security regulator's mandate from administrative control to maintaining a fair and orderly marketplace by inspecting and bringing enforcement action against any offenses according to securities law and regulations.

- Registration reform for bond issuance

In fact, we believe establishing a securities' registration process is a broader reform initiative in China's capital market. We discussed the ABS registration in the previous section, and we expect controls over fixed income market issuance to be relaxed over the next two to three years, particularly in the corporate credit market. The administrative control over corporate bond issuance will be shifted from NDRC and CSRC to the interbank bond market regulators and the Stock Exchanges.

- Relaxing access to bond futures market

We think the next policy reform from the China Financial Futures Exchange is to allow large domestic institutions such as commercial banks and insurance companies access to the bond futures market. As the largest holders of cash CGB bonds, commercial banks hold about 69% of the total outstanding CGB bonds, and insurance companies hold about 3.5% of the total market as of the end of April. Securities companies hold only 0.4% of total outstanding bonds. We believe the absence of commercial banks and insurance players in the futures market has three potential downside risks: (a) low transaction volume of the futures contract; (b) low liquidity of the futures contract; and (c) risk of specialness of bonds that are deliverable to the futures contracts.

- Developing PPP-based corporate bond market

Using the Private Public Partnership model in developing infrastructure projects is another key area in China's financing and investment reform. Demand from local governments for the PPP model has been strong, and many provinces have announced PPP projects this year that which could require investment of close to RMB1trn. Given this is the first year for the experiment of PPP-based model and financing, we believe it will take some time to sort out the legal and operational details to develop into a more standard financing model. We would expect investment interests to be concentrated on high-quality projects and therefore expect progress to be relatively slow this year.

Financial legislation reform

Following the passage of the New Budget Law in August 2014, another groundbreaking financial reform this year is the likely passage of amendments to the Securities Law. The Standing Committee of the National People's Congress has completed the first review of the draft amendments, the most comprehensive review since 1998, and this will be released to the public for feedback. After another two rounds of reviews later this year, the New Securities Law may be passed some time in Q4, and it is the most important financial legislation this year.

The amendments have been drafted based on three principals:
(a). Deregulating the financial market and letting the market play an increasingly important role in driving capital allocation;
(b). Promoting financial innovation and supporting the healthy growth of the financial market; and
(c). Strengthening the protection of medium and small investors and enforcing prosecution in the securities industry.

The specific amendments to the Securities Law focus on five areas:
(a). Establishing IPO registration; (b). deepening capital market by adding three new markets: in addition to the stock exchanges, securities can also be traded in marketplaces approved by the State Council or approved by the CSRC and/or equity-/assets-related trading market; (c) establishing investor suitability rules and strengthening protection of small investors; (d) promoting financial innovation; and (e) strengthening ex-post supervision; other changes include allowing for offering exemption to qualified investors and restricting cross-market manipulation.

Formalizing regulation on internet finance

Internet finance business – financial intermediation provided by IT giants online – has grown rapidly in the past two years and has played an important role in facilitating lending to small and micro firms, a market where traditional financial services have been under supplied and financial conditions have been quite unfavorable. Yuerbao has become one of the largest money market

funds, and currently, it has RMB712bn AUM. Internet lending via P2P platforms has grown substantially – by the end of 2014, there were 1,575 P2P platform companies, with total outstanding loan of RMB103bn, up 287% YoY. There has been strong growth in the number of participants in the P2P market, with 1.16mn investors and 620K borrowers by the end of 2014, up 364% and 320%, respectively, from 2013.
Recognizing the importance of internet finance business in China's financial reform, financial regulators on the one hand are keen to promote the growth of internet finance business, and on the other hand to assess and manage any potential risks. We expect financial and industrial regulators to formalize regulation on internet finance later this year.

Other financial legislation

In addition to the New Securities Law and regulation over internet finance business, the central bank has established financial regulation legislation as its key task in 2015. This legislation aims at improving the legal framework in regulating the financial market, such as refining exchange rate regulation, drafting the commercial banks bankruptcy rule, the Futures Law, the Trust Law, etc.

In conclusion, we believe we are standing at the most exciting moment in China's economic and financial development history, a point at which comprehensive financial liberalization reforms will be pushed out to re-orient macro policy and financial regulation toward a financially open economy with fully convertible RMB. These reforms will shape up China's new financial market, which will have deeper market structure, stronger regulatory and legal infrastructure, and can efficiently mobilize savings and allocate financial resources domestically and increasingly globally. The challenges are great, but not unconquerable, and if successful, the changes will substantially boost China's productivity growth and economic potential in the years come.

Linan Liu, Hong Kong, (852) 2203 8709

Special report: RMB may become convertible in 2015

Government aims to make RMB convertible in 2015

The government announced in March that it aims to make the RMB convertible in 2015. We believe this reform aims to help China's application to make the RMB an SDR basket currency. The IMF review on SDR currencies will likely happen in October, hence we expect significant reforms in Q2 and Q3.

We expect significant (but not full) capital account liberalization

PBoC Governor Zhou pointed out 3 sets of policy actions to open the capital account: revising the regulation guideline on exchange controls, opening more markets such as the bond market, and allowing individual investors in China and abroad to make cross-border investments.

We believe capital account liberalization may lead to net capital inflows in 2015

Capital controls are more binding for foreign investors as local residents may find ways to evade them. Hence, removing capital controls may lead to more inflows as foreign investors have limited exposure to mainland assets. Moreover, the government will be cautious in the early stages of liberalization, with policies ready to avoid disruptive outflows. Lastly, onshore and offshore interest rate differential will continue to favor inflows. The Stock Connect between Shanghai and Hong Kong also shows net inflows after its launch.

Liberalization is positive for markets, RMB, and economy in 2015

Net capital inflows should help to boost asset prices, including equities, bonds, and the RMB. On macro front, liberalization is also positive as it may trigger other structural reforms and help to fill the financing gap in the economy.

We recognize that liberalization may heighten volatility of capital flows. The government is fully aware of the risks and will likely manage such risks through macro-prudential measures.

We see 70% probability that RMB will become an SDR currency by the end of 2016

China may apply again in 2016 if the RMB fails to pass the IMF review on SDR currency in October 2015. We see 40% probability that the RMB will become an SDR currency in 2015, and 70% probability that it will happen by the end of 2016.

The recent establishment of the Asia Infrastructure Investment Bank (AIIB) shows that China is willing to play a bigger role in the international financial system, and there is wide support among developing as well as developed economies. We believe the market may be surprised in the next few years by how fast China moves on RMB internationalization and capital account liberalization.

Why China aims to make RMB convertible in 2015

Government announced in March that it aims to make RMB convertible in 2015

The government sent strong signals in March that it aims to make RMB convertible for capital account transactions in 2015. Premier Li Keqiang mentioned in his annual working report to the NPC on March 5 that "China will achieve renminbi convertibility under capital account". This is a stronger statement than what he said in his 2014 working report: "China will accelerate renminbi convertibility under capital account". Governor Zhou Xiaochuan of the People's Bank of China (PBoC) also said explicitly in several conferences in March that the government aims to make the RMB convertible in 2015.

Making RMB convertible would require capital account liberalization, a controversial topic in the policy circle till recently

We believe these messages are important for investors. It means China will likely open its capital account significantly in 2015. To put this issue into perspective, there has been a long and intensive debate about whether China should liberalize its capital accounts and make the RMB convertible. While the PBoC has been pushing this initiative for years, many influential policy advisors have spoken openly against it. Two examples are Professor Justin Lin, former chief economist at the World Bank, and Dr. Yu Yongding, former head of a research institute at the China Social Science Academy and former member of the Monetary Policy Committee at the PBoC. One argument they pointed out is that capital account liberalization often leads to financial crises. The progress on this front has been slow partly due to different views in the policy circle.

Government announcement and actions suggest RMB convertibility may happen in 2015, faster than market expectations

The messages from Premier Li and Governor Zhou suggest the debate in the policy circle has ended. A decision has been made by the leadership and it will be implemented in 2015. Indeed, we have seen solid actions by the leaders in 2014 to push for RMB internationalization. President Xi and Premier Li often promoted the RMB in their official visits to other countries (Figure 1). For instance, after Premier Li's visit to the UK in June 2014, RMB started direct trading against sterling, and the UK government issued bonds in the RMB. In November 2014, President Xi visited Australia. The official RMB clearing bank opened in Sydney and a provincial government in Australia issued RMB bonds in that month.

Government aims to make RMB an SDR currency this year. The IMF review is likely in October,…

We believe the government has decided to promote RMB internationalization as part of its strategy to enhance its global influence. The next step is clear: the government will try to make the RMB part of the currency basket for SDR (Special Drawing Rights). SDR refers to supplementary foreign exchange reserve assets defined and maintained by the IMF. Their value is based on a basket of major international currencies. Based on the latest review conducted in 2010, the SDR basket consists of four currencies: the US dollars (41.9%), euro (37.4%), pound sterling (11.3%), and the Japanese yen (9.4%).

… which requires the RMB to become convertible

To apply for becoming a SDR basket currency, the RMB needs to be "freely usable", a legal term which is subject to the judgment by the IMF. The RMB has become convertible for current account transactions such as trade and tourism, but it has not become convertible for most capital account transactions (with the noticeable exception of FDI). Hence, the IMF review of the SDR currency in October works as a commitment device for the government to push for capital account liberalization in 2015, which would strengthen the case of the RMB to become an SDR currency.

Figure 1: Major RMB internationalization events and China leaders' overseas visits in 2014

Visit date	Leadership official visit	Event/announcement date	Event/announcement
Early Apr	Premier Li Keqiang attends the Boao Forum in Sanya	Apr-10	CSRC and Hong Kong SFC jointly declare their approval of Shanghai-Hong Kong Stock Connect, allowing both institutional and individual investors to trade equities in the other market via local brokers.
Jun 16-21	Premier Li Keqiang's official visit to the United Kingdom	Jun-18	PBoC announces direct trading of RMB against the sterling, helping London's bid for RMB offshore center.
		Jun-18	China Construction Bank wins its first RMB-clearing mandate in London.
		Oct-14	UK government issues a sovereign bond in the RMB, becoming the first western country to do so and issue the largest ever non-Chinese RMB bond.
July 3-4	President Xi Jinping's official visit to Korea	July-4	PBoC authorizes the Bank of Communications to be the clearing bank for RMB businesses in Seoul.
		Oct-11	Bank of Korea and PBoC agree to extend an existing swap agreement worth KRW 64trn/ RMB 360bn to Oct. 10, 2017
July 15-23	President Xi Jinping's official visit to Brazil, Argentina, Venezuela and Cuba	Jul-18	PBoC and Central Bank of Argentina renew the bilateral local currency swap agreement of RMB 70bn/ ARP 38bn.
Aug 21-22	President Xi Jinping's official visit to Mongolia	Aug-21	Bank of Mongolia and PBoC sign a new currency swap agreement for a term of another three years, expanding its size from RMB 10bn to RMB 15bn.
Sep 11-19	President Xi Jinping's official visit to Tajikistan, Maldives, Sri Lanka and India	Sep-16	PBoC signs the Local Currency Swap Agreement with the Central Bank of Sri Lanka. The size of the swap facility is RMB 10bn/LKR 225bn.
Oct 9-15	Premier Li Keqiang's official visit to Russia	Oct-13	PBoC signs a currency swap agreement worth RMB 150 bn with the Russian central bank.
Nov 14-23	President Xi Jinping's official visit to Australia, New Zealand and Fiji	Nov-18	Bank of China is named as the official clearing bank for the RMB in Australia and agrees to boost cooperation with ASX Ltd., operator of the country's main stock exchange.
		Nov	Australia's New South Wales Treasury Corp issues an RMB 1bn bond, the first such debt issued by an Australian government entity.
Dec 14-20	Premier Li Keqiang's official visit to Kazakhstan	Dec-14	China and Kazakhstan decide to renew their three-year currency swap deal of RMB 70bn.
Other major events		Mar-15	PBoC widens the daily trading band of USD/CNY to +/-2% around the fixing rate, effective March 17.
		Jun-27	PBOC liberalizes for small-scale foreign currency deposits in Shanghai.
		Jul-4	PBoC and SAFE grant banks the right to set their own rates for RMB/dollar exchange with retail clients on the basis of market demand.
		Jun-Jul	More RQFII quota granted to French, German and Korean investors.
		Sep 30	China starts direct trading between the RMB and the euro.
		Oct 28	China launches direct currency trading of the RMB and the Singapore dollar.

Source: Deutsche Bank, Xinhua, other news media

We expect significant (but not full) capital account liberalization in 2015

China's capital account will become more open but not fully open

To be clear, we do not expect full capital account liberalization to happen in 2015. The status of capital account openness is not a bipolar choice. Instead, it is a spectrum. On one end we have economies such as Hong Kong and Singapore with few capital controls. On the other end we have closed economies where all capital account transactions need approval. Most countries are located along the spectrum, with developed economies with only minor capital controls and many developing countries with pervasive capital controls.

PBoC governor pointed out 3 dimensions of policy actions to open the capital account

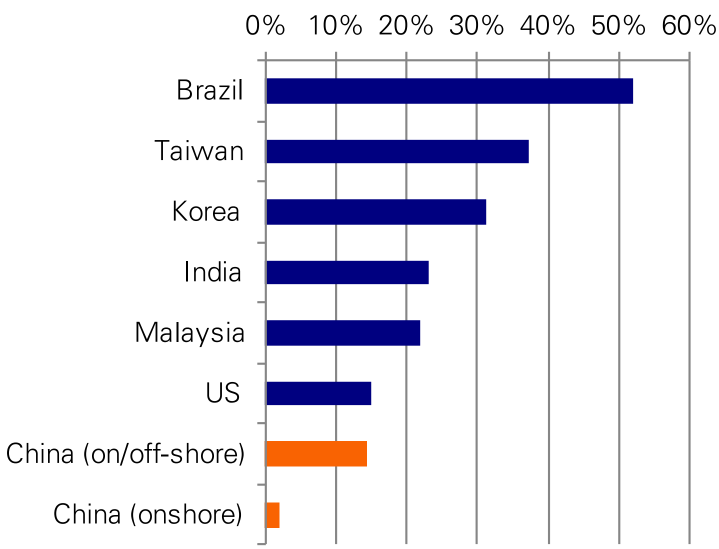
In China's case, we believe the government may implement significant liberalization measures. China will not become Hong Kong, but there are many things that can be done to facilitate cross-border investments. Governor Zhou mentioned that the government will push capital account liberalization in three dimensions:

- Facilitate cross-border portfolio investment by foreign and Chinese individual investors. The QFII and RQFII schemes may become more convenient and flexible.
- Open more markets to foreign investors. The Shanghai-Hong Kong Stock Connect has worked successfully. We expect the bond market as well as the Shenzhen equity market will likely be opened to foreign investors.
- Revision of the "Regulations on the Foreign Exchange System" (RFES). The RFES was last revised in 2008. This has been a bottleneck for capital account liberalization. The revision of RFES will allow capital account liberalization and RMB convertibility.

Currently, foreign ownership of Chinese equity and bonds is limited

Indeed, the foreign ownership of the Chinese equity market shows there is high potential for liberalization. The share of Chinese equities owned by foreign investors is merely 1.8%, far lower than other major developing economies (Figure 2). In the bond market, the share owned by foreign investors is also as low as 2.3%, vs. 6.8% in Korea or 40% in the US. The QFII and RQFII quotas are not yet fully utilized but that is partly a reflection of the convenience and flexibility of such schemes.

Figure 2: Equity market cap owned by foreign investors, int'l comp



Source: Deutsche Bank, PBoC, CSRC, WIND, CEIC, BOVESPA, TWSE, KOSPI, SEBI, Bloomberg, US Treasury

Capital account liberalization may lead to net capital inflows in 2015

Some may worry that capital account liberalization will lead to capital outflows and crisis

One concern among investors is that capital account liberalization may lead to massive capital outflows and impose financial risks in China. Many emerging markets have experienced crises, the latest example being Russia. Indeed, capital flows have turned more volatile in recent years in China as growth slows and the property bubble may burst.

We expect capital inflows in 2015, as capital controls are more binding for foreign investors,…

We believe capital account liberalization may actually lead to net capital inflows in 2015, for three reasons. First, capital controls may be more effective against foreign investors than local investors. China's capital controls are porous. As mainland Chinese can easily travel to Hong Kong, capital flows across Hong Kong and the mainland have become difficult to control. Foreign investors far away from China may find it much more challenging to move capital into China. Hence, removing capital controls may lead to more inflows, as controls are more binding for foreigners, who are more likely to move money into China when restrictions are removed, as they do not have much exposure in China at this stage.

... government policies will help to avoid disruptive outflows,...

The second reason is government policy design and intervention. The risks of disruptive capital outflows are obvious for emerging markets such as China. The government is well aware of such risks. We expect the government will design capital account liberalization in such a way to avoid outflows getting out of control. They will likely be very cautious, particularly in the early stages.

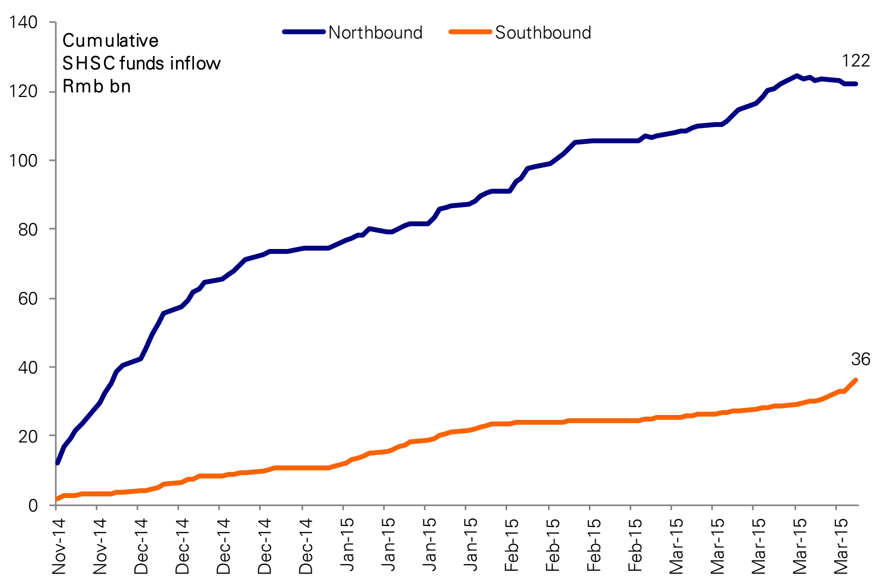
... and interest rate differential will continue to favor inflows

The third reason is the interest rate differential between China and the rest of the world. While the government has entered a rate-cut cycle and the Fed may start hiking rates in 2015, the rate differential may continue to favor China. For instance, the yield for the 10-year government bond in China is around 3.5%, much higher than those in G3. The lack of foreign ownership is due to lack of access to the bond market in China rather than a lack of appetite. As the bond market may be opened to foreign investors, bond-related inflows can be significant.

The Stock Connect led to net capital inflows

The experience of the Stock Connect between Shanghai and Hong Kong supports our view. After its launch in November 2014, the capital inflows to Shanghai totaled RMB 122bn, higher than the RMB 36bn of capital outflows from Shanghai to Hong Kong (Figure 3). We expect this initiative to be expanded to the Shenzhen stock exchange and the bond market in 2015, which should lead to more capital inflows.

Figure 3: Cumulative Shanghai-Hong Kong Stock Connect fund flows



Source: Deutsche Bank, Bloomberg Finance LP

Implications for financial markets and economy

Capital account liberalization is positive for the financial markets...

We believe capital account liberalization is positive for China's financial markets. The short-term benefit is net capital inflows that help to boost and sustain equity valuation and bond demand. The long-term benefit is that global institutional investors may help to strengthen the development of these markets in China. The outward investment would help to diversify Chinese residents' financial portfolio globally and make outward direct investment more convenient.

The liberalization is positive for the RMB. The net capital inflows will help to keep RMB exchange rate stable against the US dollar. We maintain our view that the USD/CNY exchange rate will end this year at 6.2, flat from the end of 2014. The market consensus expects a depreciation of the RMB against the US dollar. While we see the risks of our forecast are tilted toward a small depreciation, we believe the market may underestimate the progress on RMB convertibility in 2015 and the potential positive implications.

… and it is supportive for the value of renminbi

On macro front, capital account liberalization is positive as well. A profound implication is that it may trigger other structural reforms. This effect is particularly strong on financial reforms. Capital account liberalization will likely make interest rate liberalization more urgent, which in turn requires deposit insurance. Indeed, China announced in March that the deposit insurance scheme will be rolled out in May. This policy has been discussed for many years. The commitment on RMB convertibility may have helped to push it through.

Liberalization helps the macro economy as it may trigger other structural reforms…

Another benefit is that capital inflows may help China to fill its financing need. China faces a fiscal challenge in 2015 as its land sale revenue has dropped sharply (see our reports *China's unexpected fiscal slide* on January 5 and *Fiscal slide worsened, policy easing cycle may start soon* on March 17). We estimate the size of the central government's financing gap may be 3.7%. The government has announced a plan to issue RMB 1trn worth local government "debt replacement" bond. We expect more bond issuance may be announced later this year. This suggests the total new issuance of bonds will likely rise sharply in 2015 and the next few years. Opening up the bond market helps to leverage foreign capital for domestic financing.

… and it helps to fill the financing gap left by weakening land sale revenue

We recognize that liberalization may heighten the volatility of capital flows. Many emerging markets have experienced financial crises after capital account liberalization. Hence, we believe the government will be careful and avoid full liberalization in 2015. Nonetheless, the government likely has made the judgment that risks are manageable through macro-prudential measures, and the benefits of liberalization outweigh the risks.

Liberalization may potentially bring financial risks. The government will manage risks through macro prudential measures

We see 70% probability that RMB will become an SDR currency by the end of 2016

The IMF will likely review the RMB application to become an SDR basket currency in October 2015. This review of the SDR basket currencies has happened every five years in the past. However, if the RMB application is not successful this year, China may apply again in 2016 if the Chinese authorities believe significant progress has been made to make the RMB eligible.

China may apply again in 2016 if the RMB fails to pass the IMF review on SDR currency in October 2015

The Treasury Secretary of the US government said on March 31 that the RMB is not ready to become an SDR currency. We expect there will be significant reforms to make the RMB convertible in 2015. President Xi Jinping will visit the US in September, before the IMF SDR review in October. We expect the SDR application may be an issue to be discussed during his visit.

We expect more reforms and diplomatic negotiations in Q2 and Q3

We see 40% probability that the RMB will become an SDR currency in 2015, and 70% probability that this will happen by the end of 2016. The share of RMB usage in the global payment system continues to rise. The RMB will become more convertible under the capital account as well. The case of the RMB's application to become an SDR currency will become stronger over time.

We see 40% probability that the RMB become an SDR currency in 2015, and 70% probability that it will happen by the end of 2016

The recent establishment of the Asia Infrastructure Investment Bank (AIIB) shows that China is willing to play a bigger role in the international financial system, and there is wide support among developing as well as developed economies. We believe the market may be surprised in the next few years by how fast China moves on RMB internationalization and capital account liberalization.

The establishment of the AIIB shows the market may be surprised by the potential of the RMB in the next few years

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Economic Outlook

China has entered a significant policy easing cycle since end March. After the April 100bp RRR cut, the PBoC cut one-year benchmark rates by 25bp on 11 May and also lifted the ceiling of deposit rate to 1.5x of benchmark rate from 1.3x. We revise our interest rate call and expect two further cuts in 2015 – the next cut in June and another cut in Q3. We reiterate our view that M2 growth should pick up in Q2 and rise to 14%yoy by the end of 2015.

We maintain our view that growth may slow to 6.8% in Q2, and rebound to 7.0% in Q3 and 7.2% in Q4. Risks to our growth outlook in H2 are tilted to the downside.

Significant policy easing cycle

After the April 100bp RRR cut, the PBoC cut one-year benchmark deposit and lending rates by 25bp on 11 May. The PBoC also lifted the deposit rate ceiling to 1.5x of the benchmark rate from 1.3x in the past. This rate cut is in line with our expectation. We revise our interest rate call and expect two further cuts in 2015 – the next cut in June and another cut in Q3. We continue to expect one more RRR cut in Q3. Our detailed comments are:

1. We believe there is a stronger sense of urgency in the policy circle. Export growth was strong in January and February but turned negative in March and April. The official PMI remains at 50.1 while the HSBC PMI slowed to a 12-month-low of 48.9 in May. Policy makers likely realized that the risks of missing the 7% growth target were rising.

2. How much room is there for PBoC to cut benchmark interest rate? We now expect two further interest rate cuts in the rest of 2015. We do not expect more because we believe CPI inflation may start rising in H2, and real interest rates may turn negative. The key issue is whether CPI will rise in the rest of 2015. We believe it will in H2, as commodity prices have started to rebound in recent months, and the pork price in China faces upside risks given its current abnormally low level.

3. One critical question on our mind is to what extent and how quickly the size of PBoC's balance sheet will expand. The PBoC made it clear in its Q1 Monetary Policy Report that China does not need "quantitative easing" as it has plenty of policy room. We believe China may not need to replicate exactly the QE policies of the developed countries, but the PBoC will highly likely get involved in financing the fiscal gap, as we expect RMB4trn of government bonds to be issued in 2015. Without intervention from the PBoC, such issuance would drive up market interest rates and slow growth. One possibility is for the banks to purchase the government bonds. They may then use the bonds as collateral to borrow from the PBoC through some discount facility.

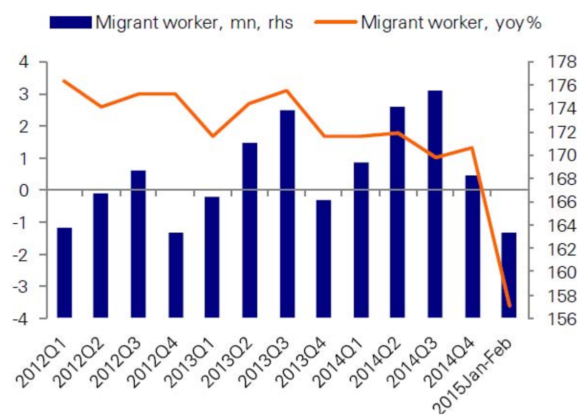
4: Interest rate liberalization took another significant step. With the deposit rate ceiling pushed to 1.5x of the benchmark rate, large banks may not lift their deposit rates to the ceiling, hence effectively interest rate regulation may not be binding for many banks. This paves the way for capital account liberalization which we believe will be rolled out faster than market expectation.

5. We maintain our view that growth may slow to 6.8% in Q2, and rebound to 7.0% in Q3 and 7.2% in Q4. Risks to our growth outlook in H2 are tilted to the downside. We continue to expect growth to decelerate to 6.7% in 2016.

Sharp slowdown in Q1 requires easing

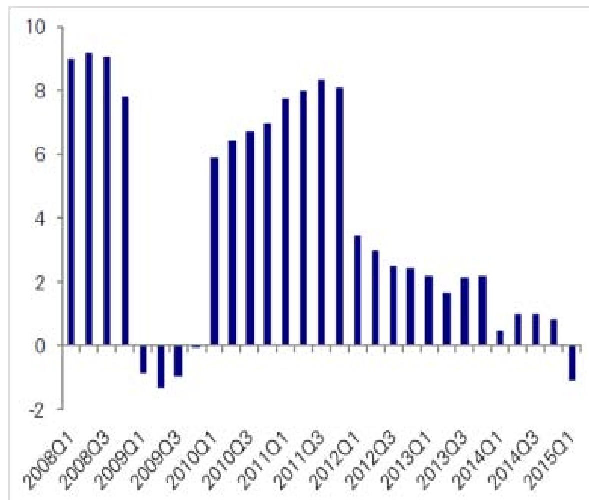
The Q1 economic data release suggests such risks are indeed rising. The headline GDP growth slowed only moderately to 7.0% in Q1 from 7.3% in Q4. Yet the nominal GDP growth was merely 5.8% yoy, the lowest since 5.7% yoy growth in Q1 2009. Moreover, IP growth plummeted to 5.6% in March from 6.8% in Jan and Feb and 8.3% in 2014. This is comparable to what happened during the global financial crisis, when IP growth dropped to 5.4% in November 2008. Industrial level indicators slowed more severely. Electricity production growth dropped to -0.1% yoy (Jan-Feb: 1.9%, 2014: 3.2%). Cement output growth dropped to -20.5% (Jan-Feb: 11.2%, 2014: 1.8%).

Figure 7: Migrant worker number and growth



Source: Deutsche Bank estimates, WIND, CEIC

Figure 8: GDP deflator, ytd, ppts



Source: Deutsche Bank, CEIC, WIND

Another indicator that worries us is the number of migrant workers, which dropped 3.6% yoy in January-February. This indicator is not widely watched by the market, but we believe it is important, as it shows how economic conditions affect the labor market. The government only started to publish quarterly data from 2012. This is the first time the number of migrant workers has dropped yoy since the data became available. We believe this may suggest the weak economy is starting to weigh on the labor market, similar to what happened in 2009.

The third alarming signal is the GDP deflator which dropped to -1.1% from 0.8% in 2014. This is the first time since 2009 that the deflator has dropped to negative. This may be the reason why PBoC Governor Zhou commented that the risk of deflation deserves attention. It will amplify the fiscal shock as the fiscal revenue is pro-cyclical and sensitive to the price effect.

Growth of FAI also slowed to 13.5% yoy ytd in March from 13.9% in January-February. Infrastructure FAI growth picked up 2.5ppts from 23.1%, while manufacturing FAI growth slowed 0.2ppts to 10.4% and property investment growth slowed to 8.5% from 10.4%. Property sector indicators remain weak. YTD property sales growth rebounded to -9.3% in March from -15.8% in January-February, but developers' land purchase growth remained weak at -32.4% yoy ytd vs. -31.7% in January-February.

Moreover, a large fiscal shock occurred in Q1. Both budgetary and government fund accounts weakened significantly. Total government income was down 6.1%yoy in Q1 vs. +7.1% growth in 2014. This is consistent with the six-year-low nominal GDP growth in Q1 of 5.8%. It may trigger significant policy easing.

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Equity Strategy

We see an extended market consolidation in the near term on the back of 1) subtle policy tone change; 2) waning market liquidity inflows; and 3) unattractive valuations, while maintain a positive stance on Chinese equities in the medium term; we reiterate the key word for 2015 is the "R.R.R." (rate-cut and reform drive re-rating).

Valuation no longer looks compelling

For full-year 2015, we reiterate our view that the key word for 2015 is the "R.R.R." (see 2015 China Outlook - Rate-cut, reform & re-rating in the Year of the Ram, 5 January) and maintain a positive stance on Chinese equities in the medium-term, given **1)** more policy easing and expediting reforms in China ay raise investors' expectations on cyclical and structural prospects; and **2)** synchronized global monetary loosening and Chinese private sector capital reallocation propel funds inflow to H-shares. **Sector wise**, we suggest overweight financials, info tech, industrials and utilities, underweight telecom and energy and market-weight consumers, healthcare and materials.

However, **in the near term, we expect the market to consolidate further** on the back 1) unfavorable subtle policy tone change; 2) waning market liquidity inflows; and 3) unattractive valuations (see Three reasons why the market may consolidate further in near term, 6 May). Specifically,

We noted an unfavorable subtle policy tone change lately. CSRC has launched a regulatory campaign since mid-April to rein in margin financing and insider dealing, for example, the securities watchdog started to curb shadow margin financing schemes (see CSRC Tightens Shadow Margin, 18 April) and most recently discussed capping brokers' capacity to borrow from banks via Margin Financing Beneficiary Rights repos (see CSRC Regulatory Campaign Continues, 8 May). We think these signaled the regulator's concerns about the rapid A-share leverage build-up.

Market liquidity inflows waned. We have seen escalating A-share IPO funds freeze, rising net redemptions in offshore listed A-share ETFs, slower pace of margin debt buildup and waning funds inflow to H-shares.

Valuations no longer look compelling. For H-shares, MSCI China trades at 12x 12m forward P/E, and non-financials are already at 16x, one standard deviation above its 10-year average. A-shares are trading at even richer valuations (see Gazing at A-share Valuations, 14 May), given 1) CSI300 at 16.5x forward P/E and non-financials at 22x, the small-cap CSI500 is at 34x; 2) more than half of A-shares trade at over 50x 12m trailing P/E; and 3) current 2.7% CSI300 IERP (implied equity risk premium) is below its 4.1% 10-year average and lower than the risk free rate of 3.4% 10-year CGB yield.

We believe aggregate system liquidity is quite abundant after continuous PBoC liquidity injections YTD, while the key bottleneck is insufficient effective credit demand, as the traditional demand drivers including LGFVs and property were contained while demand from the new economy sectors is still quite small in size.

To make us more positive on the market, we would like to see more expansionary fiscal (increasing public expenditure and rising infrastructure investment growth) **and quasi-fiscal operations** (e.g. designated liquidity facilities to key policy banks), boosting credit demand and **sending broad**

credit growth (M2 or TSF) higher. This should stabilize the domestic economy and raise market expectations on GDP and earnings growth outlook in 2H15.

In addition, **we want to see more progress around financial and SOE reforms** to unleash long-term growth potential by addressing supply-side constraints. With these efforts, global investors could improve their **long-term structural outlook on China** and may be willing to demand less risk premium and pay higher multiples for Chinese equities.

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Fixed Income Strategy

We expect interbank liquidity to remain flush and we maintain our forecast that 7D repo rate will stabilize at around 2%. We continue to see a steepening bias on the IRS/NDIRS curve and we keep our 5Y receiving NDIRS position with a revised target of 2.25% from 2.5%. We continue to recommend trading the CNH CCS curve in a range with a bullish bias and hold our receiving position in 1Y CNH CCS rates with a revised target to 2.6% from 2.9%.

On the onshore credit market, we continue to expect the weaker credit to underperform and recommend asset allocation in the liquid high grade names.

Mitigating supply risk in Q2

Policy and liquidity outlook

PBoC cut rates and further liberalizes the deposit rate On May 11th, the PBoC cut the 1Y policy deposit rate and 1Y policy lending rate by 25bps (parallel shift of the policy rate curves and only demand deposit rate was unchanged at 0.35%) and widened the deposit rate ceiling from 1.3x to 1.5x the policy deposit rates.

We believe the policy move has four main market implications:
(a) Large banks likely will keep deposit rate ceiling at 1.2X the policy deposit rate curve. With deposit insurance having taken effect since May 1st, we expect limited deposit competition among deposit taking institutions and we expect large banks to keep the deposit rate ceiling at where they were before the rate cut at around 1.2x, while smaller banks may leave their deposit at between 1.3x to 1.5x; (b) We forecast the 7D repo rate to stabilize at around 2%. Following the cut, we expect approximately 20-25bps reduction in large banks' average funding cost to around 2-2.3%, while will stabilize the 7D repo rate at around 2%. (c) The cut is supportive to bond market demand and help mitigate the supply risk. (d) Deposit rates will be fully liberalized later this year. The widening in the deposit rate ceiling affirms our view that deposit rates will be fully liberalized later this year as the market deposit rate pricing has already began to differentiate since the previous rate cut on March 1st and the new ceiling gives sufficient room for banks to enhance their deposit pricing capacity. (e) Monetary condition will continue to ease. Our chief China economist, Zhiwei now calls for two more interest rate cuts in the rest of 2015 and more RRR cuts in Q3.

Managing municipal bond supply risk via private placement

The Ministry of Finance, PBoC and CBRC jointly approved the Notice of 2015 Municipal bond private placement on May 8th. Based on a copy obtained online, we highlight four key points in the Notice.

1. Local governments are allowed to issue municipal bonds via private placement to swap the outstanding local government debt which are in the form of bank loans or financing provided by trust companies, securities companies, insurance and other financing institutions and the debt swap amount is according to the June 2013 National Government Debt Audit Report. Out of the RMB10.88trn local government direct obligation, about RMB6487bn (RMB5.52trn bank loans, RMB762bn trust financing and RMB200bn financing by securities companies, insurance and other financing institutions) will be eligible for such swap. The private placement of municipal bond is to target special creditors of outstanding local government debt including banks, trust companies, securities companies and insurance companies.

There is RMb1.8trn redemption of local government direct obligation in 2015, although we do not have the breakdown of various financing types, we believe over 50% of the redemption is bank loans which will be qualified for the swap. This means most of the RMB1trn quota for local government debt swap will be filled by privately placed municipal bonds, and the budgeted net supply of RMB600bn municipal bonds will likely be issued via interbank bond market placement. The debt swap is scheduled to be completed by August 31st.

2. Both general obligation bonds and special project bonds can be issued via private placement. Tenor for GO bonds are 1Y, 3Y,5Y,7Y and 10Y with no more than 30% of the total placement in any single tenor, while tenors for SP bonds are 1Y, 2Y, 3Y, 5Y, 7Y and 10Y with the placement in the latter two tenors at no more than 50% of the total size of the private placement. The tenor distribution requirement is the same as that in the market placement for municipal bonds.

3. Pricing guidance of such municipal bonds is set between 1x to 1.3x CGB yield curve. The Issuing yield of municipal bonds via private placement should be floored at 1x the previous five-working day moving average CGB yield of the same tenor and the ceiling is set at 1.3X the prior mentioned moving average yield of CGBs. While the floating range of 0.3X CGB yield level is a decent buffer for credit risk pricing differentiation among local governments, we think realistically, 1.1X the CGB curve is more likely, implying the 3Y-10Y municipal yield curve at 3.3-3.7% in reference to the current CGB curve.

4. Privately placed municipal bonds are not allowed for cash trading in the interbank bond market or the Stock Exchanges, but can be traded over the counter at pilot commercial banks. However, such municipal bonds are eligible as collateral for Treasury cash management and local treasury cash management in pilot regions, and PBoC's targeted lending facilities such as the SLF, MLF, PSL and commercial banks collateralized loans, and can be accepted in the market repo transactions.

We believe the clarification on collateral eligibility has two implications:

(a) Support demand by policy banks and commercial banks because they have access to all of the above liquidity facilities;

(b) To offset the poor secondary market liquidity, the PBoC is willing to provide liquidity to banks on a targeted basis by adding such municipal bonds to the collateral pool, but it has to be accompanied by expanding the size of PBoC's various liquidity facilities to achieve the goal of easing monetary condition, otherwise it is merely a substitution effect. Note each of these facilities carry its own monetary policy transmission and affect funding cost at different tenors and sectors-- the SLF (Standing Liquidity Facility) is to smooth short term liquidity and is also available from local PBoC branches; the MLF (Medium term Liquidity Facility) requires banks provide financing to SME and the agriculture sector and the PSL (pledged supplementary lending currently only to CDB) supports lending to Shanty town renovation projects and other infrastructure developments. Treasury cash management is to make use of fiscal deposits for temporary liquidity management. The PBoC has injected liquidity via the above targeted tools in recent years, taking CGBs, policy bank bonds, and highly rated papers as collateral. Now adding municipal bonds to the collateral pool has to be accompanied by expanding the size of PBoC's various liquidity facilities to achieve the goal of easing monetary condition, which depends on the overall macro condition, financing condition and monetary supply growth, otherwise it would simply substitute other eligible collaterals such as CGBs etc. We believe the policy implication is that the PBoC will employ more targeted quantitative tools during Q2/Q3 to manage liquidity (in addition to the 15pbps cuts in RRR YTD, and RMB334.7bn SLF and

RMB1014.5bn MLF in Q1 this year.

On the other hand, it seems such municipal bonds are not accepted for PBoC's open market operations for now because it would involve PBoC's direct purchase of municipal bonds, which is prohibited according to China's Central Bank Law.

Trading strategy

Both the recent interest rate cut and the private placement arrangement affirms our view that municipal bond supply risk is manageable. As Jiangsu province announced detailed financing plan on May 12th and is scheduled to re-launch its municipal bond auction on May 18th, we expect municipal bond issuance to gather pace in the coming three months.

We expect bond market sentiment to improve gradually, however in the near term appetite for duration extension will remain modest unless PBoC expands long term liquidity provision through the PSL. As such CGB curve is likely to bull steepen but the long end may continue to underperform IRS.

We expect interbank liquidity to remain flush and we maintain our forecast that 7D repo rate will stabilize at around 2%. We continue to see a steepening bias on the IRS/NDIRS curve and we keep our 5Y receiving NDIRS position with a revised target of 2.25% from 2.5%. We continue to recommend trading the CNH CCS curve in a range with a bullish bias and hold our receiving position in 1Y CNH CCS rates with a revised target to 2.6% from 2.9%.

On the onshore credit market, we continue to expect the weaker credit to underperform and recommend asset allocation in the liquid high grade names.

Bond market technical update

Total outstanding bonds in the interbank bond market grew by 1.6% YTD and 0.7% MoM in April. Total outstanding bonds in the interbank bond market grew by 1.6% YTD and 0.7% MoM from March to RMB29.197trn in April. Total domestic bond market (including the Stock Exchanges) size was up by 1.65% MoM to RMB37.624trn.

Commercial banks and fund houses were the top buyers in April

Supported by improving interbank liquidity condition, commercial banks and fund houses bought the most bonds in April. Commercial banks net bought RMB92bn in the interbank market, about 42.5% of the monthly net supply, while fund houses bought RMB70bn, about 32.3%. Insurance companies net sold RMB2bn bonds, and foreign investors with interbank bond market access net bought RMB9bn. Securities companies net bought only RMB1bn bonds, reflecting largely their preference in the equity market.

On a YTD basis, commercial banks net bought RMB238bn bonds, about 51% of the YTD net supply, followed by fund houses which net bought 26%, trust cooperatives net bought 8%, foreign investors with direct interbank bond market access net bought 7%, and insurance companies net sold 4%.

By the end of April, commercial banks held 63% of the interbank bond market, followed by fund houses at 12%, and insurance companies at 8%. Foreign investors with direct interbank bond market access held 2%. The Stock Exchanges held 4% of the interbank bonds after net sold RMB4bn bonds in April, which in our view, indicates mostly QFII investors positioning.

Specifically, commercial banks increased holdings of policy bank bonds, CGBs and credit bonds, and fund houses increased holdings of policy bank bonds and credit bonds.Both insurance companies and securities companies increased holdings of CGBs and policy bank bonds, and reduced credit exposures. Offshore investors with interbank bond market access bought CGBs and credit bonds, while reduced policy bank bonds.

Asset allocation by the end of April

Commercial banks allocated 44% of their fixed income portfolio in policy bank bonds and 32% in CGBs, while offshore investors allocated 42% of their portfolio in CGBs and 41% in policy bank bonds. Fund houses allocated 32% of their assets in policy bank bonds and 59% in credit bonds, and insurance companies with 28% in policy bank bonds, and 44% in credit bonds.

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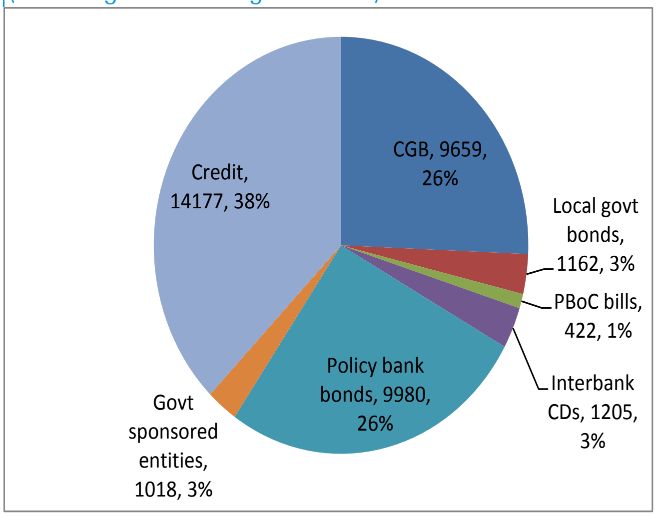
Chart Pack

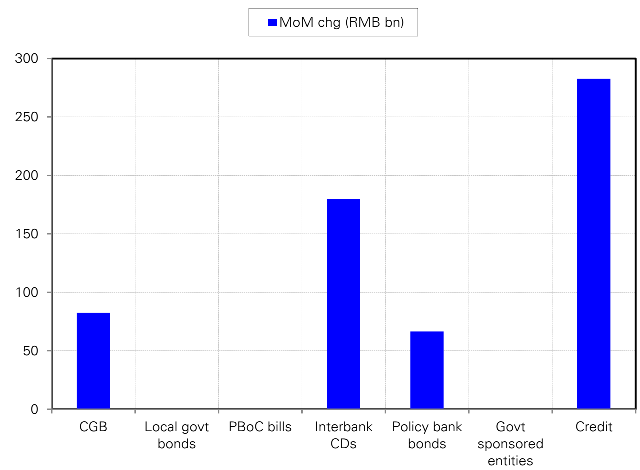
Domestic bond market view

Figure 9: Breakdown of domestic bond market (RMB bn) (including the Exchanges market)



Source: Deutsche Bank,.CEIC, WIND

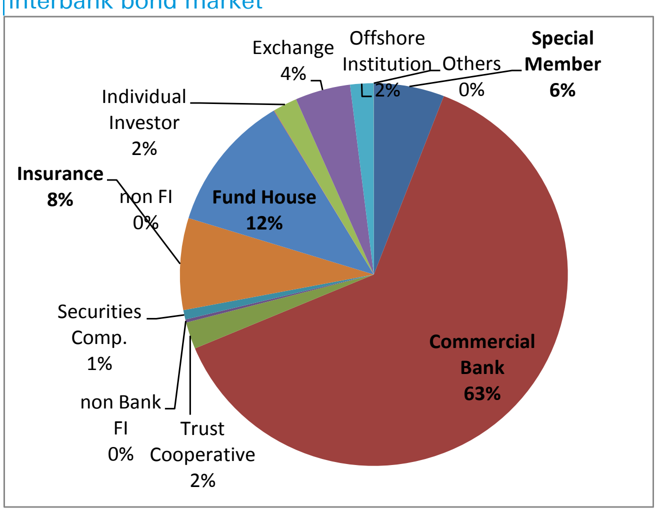
Figure 10: MoM changes in outstanding bonds (RMB bn)



Source: Deutsche Bank, CEIC, WIND

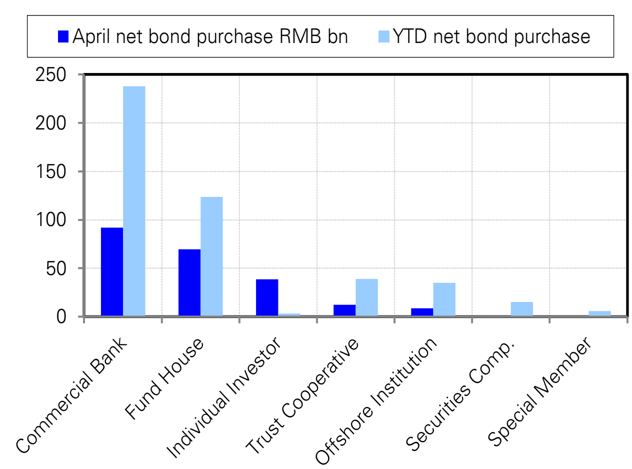
Total bond holdings and MoM and YTD changes by investors

Figure 11: CNY bond holdings by investors in the interbank bond market



Source: Deutsche Bank, Chinabond

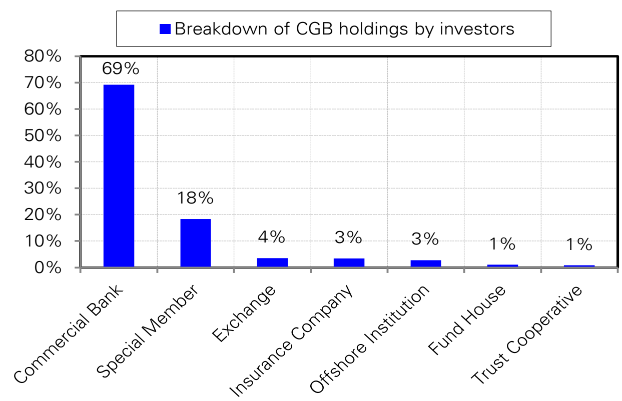
Figure 12: Net purchase of bonds by investors



Source: Deutsche Bank, Chinabond

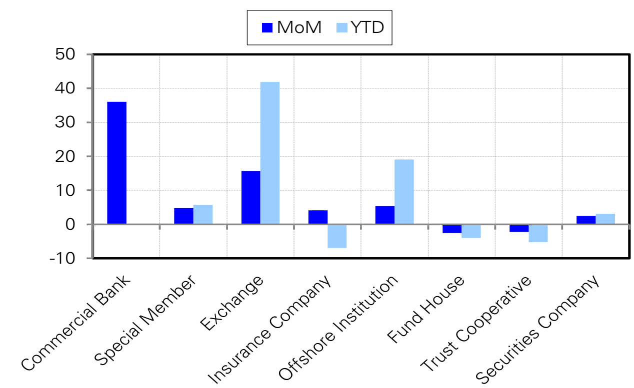
Breakdown of bond type by top holders and MoM and YTD changes by investors

Figure 13: Top holders of CGBs by market share



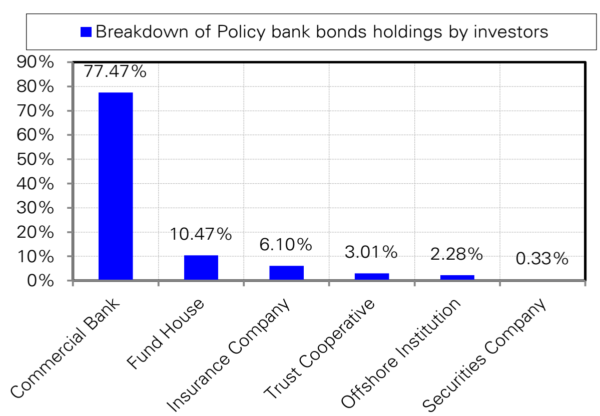
Source: Deutsche Bank,Chinabond

Figure 14: Net purchase of CGBs by top investors (RMB bn)



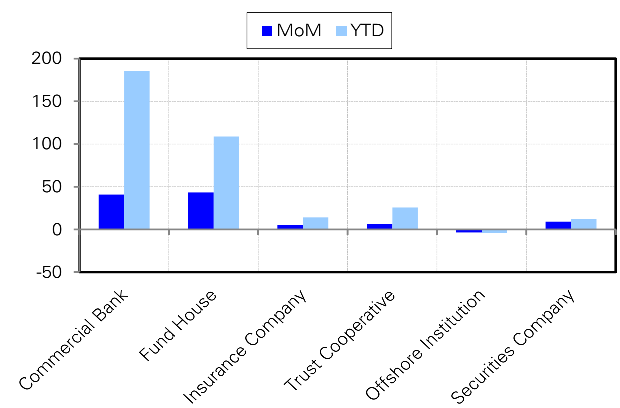
Source: Deutsche Bank, Chinabond

Figure 15: Top holders of policy bank bonds by market share



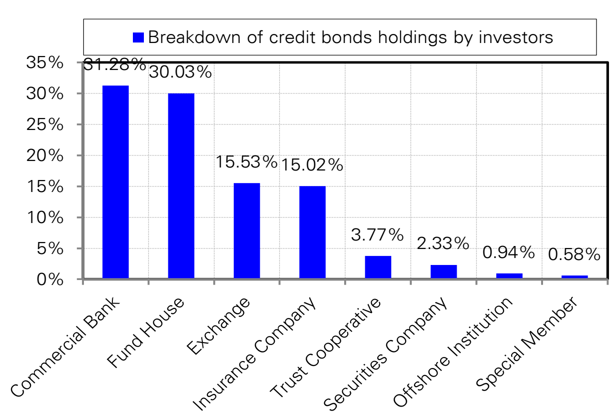
Source: Deutsche Bank, Chinabond

Figure 16: Net purchase of policy bank bonds by top investors (RMB bn)



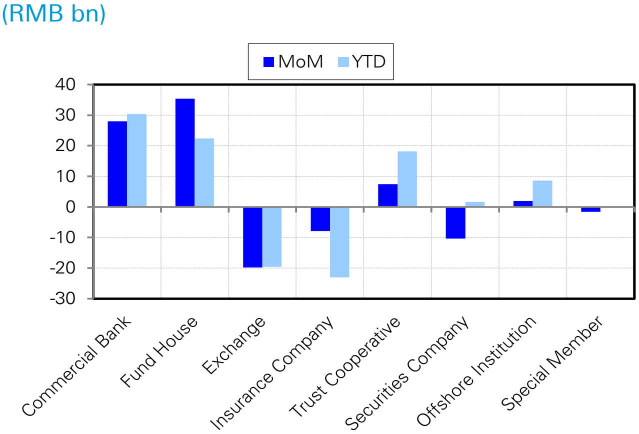
Source: Deutsche Bank, Chinabond

Figure 17: Top holders of credit bonds by market share



Source: Deutsche Bank, Chinabond

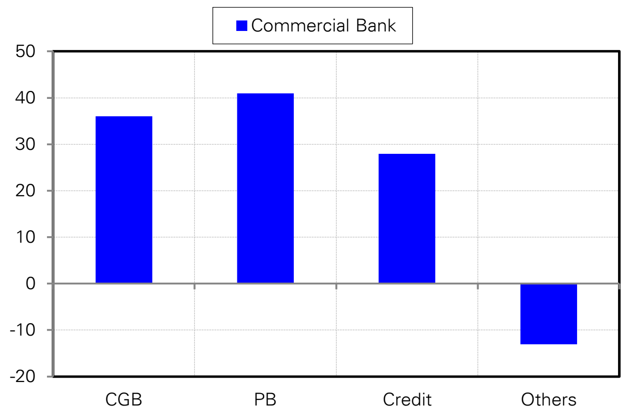
Figure 18: Net purchase of credit bonds by top investors (RMB bn)



Source: Deutsche Bank, Chinabond

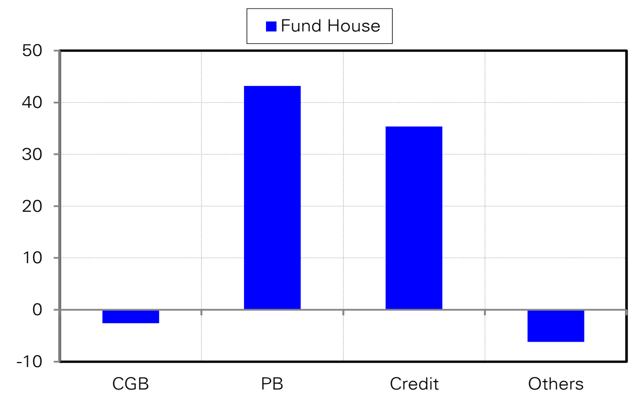
Breakdown of monthly positioning change by key investors

Figure 19: Commercial bank April net purchase (RMB bn)



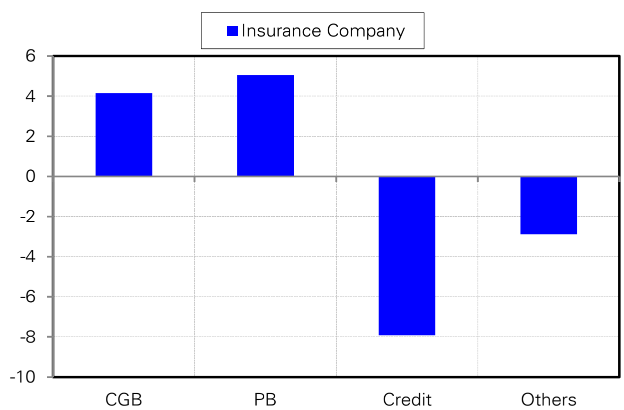
Source: Deutsche Bank, Chinabond

Figure 20: Fund house April net purchase (RMB bn)



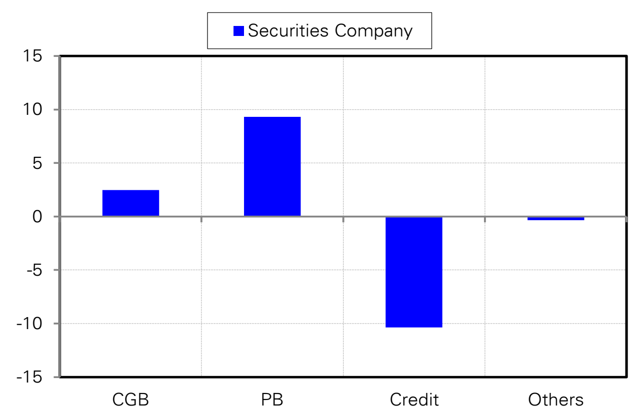
Source: Deutsche Bank, Chinabond

Figure 21: Insurance company April net purchase (RMB bn)



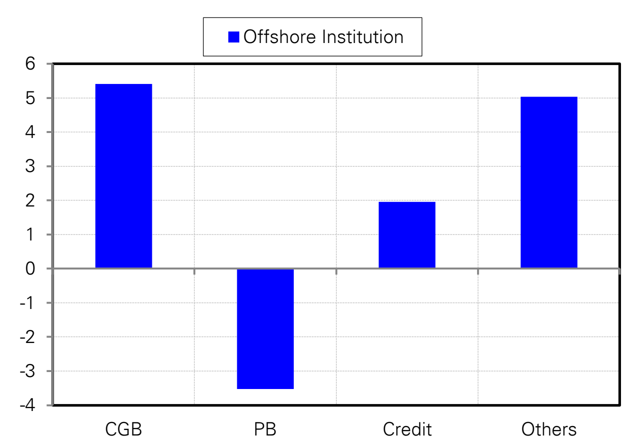
Source: Deutsche Bank, Chinabond

Figure 22: Securities company April net purchase(RMB bn)



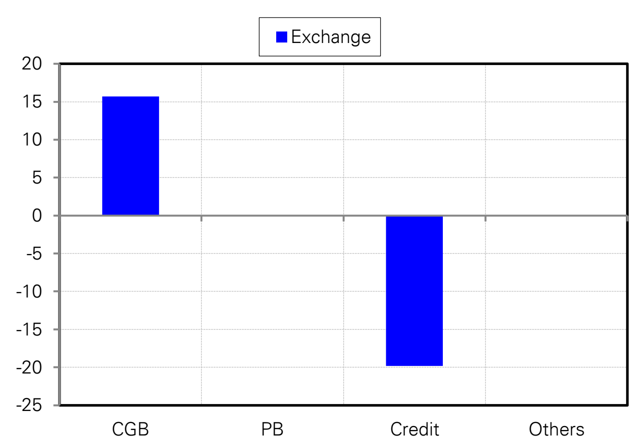
Source: Deutsche Bank, Chinabond

Figure 23: Offshore investors April net purchase (RMB bn)



Source: Deutsche Bank, Chinabond

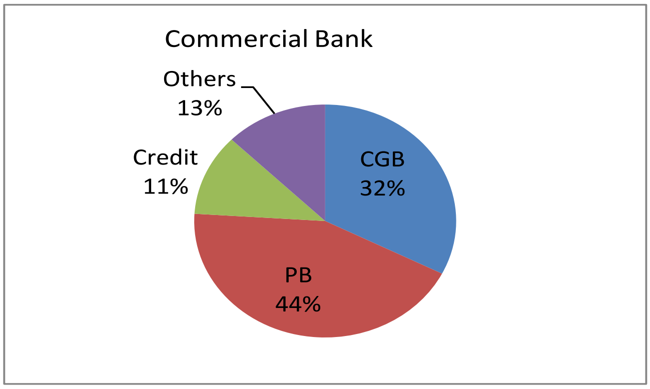
Figure 24: Exchanges April net purchase (RMB bn)



Source: Deutsche Bank, Chinabond

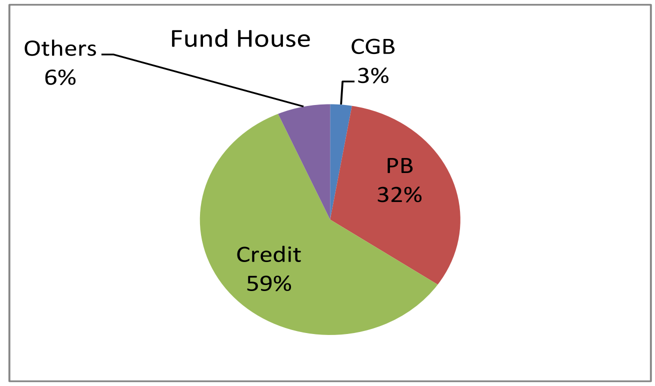
End of April fixed income portfolio allocation by key investors

Figure 25: Commercial bank



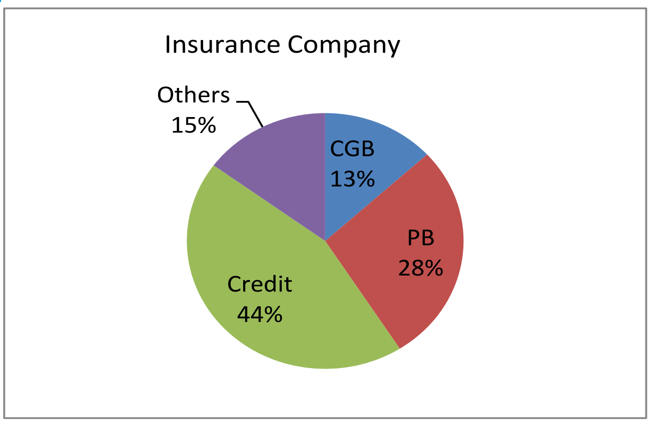
Source: Deutsche Bank, Chinabond

Figure 26: Fund house



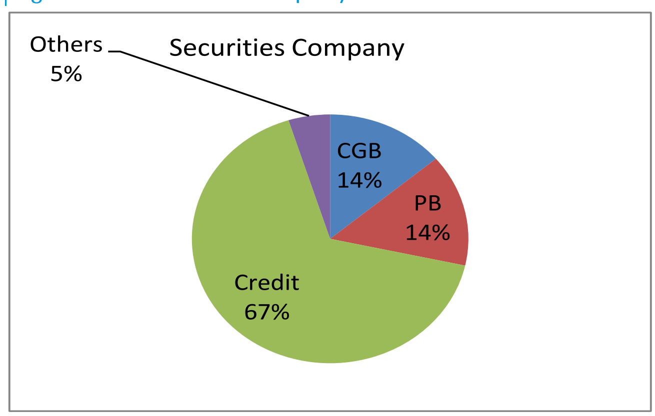
Source: Deutsche Bank, Chinabond

Figure 27: Insurance company



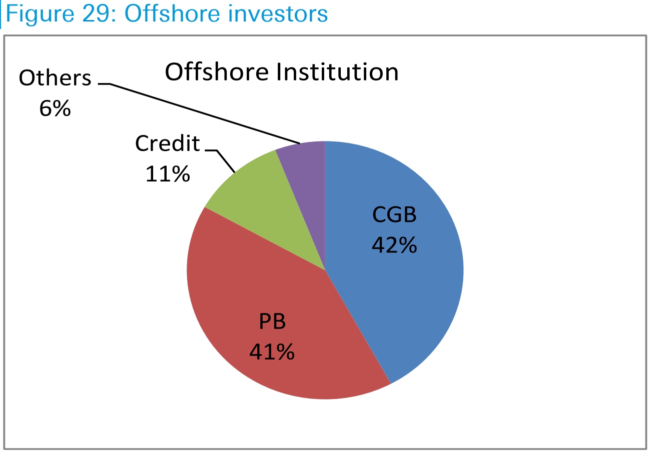
Source: Deutsche Bank, Chinabond

Figure 28: Securities company



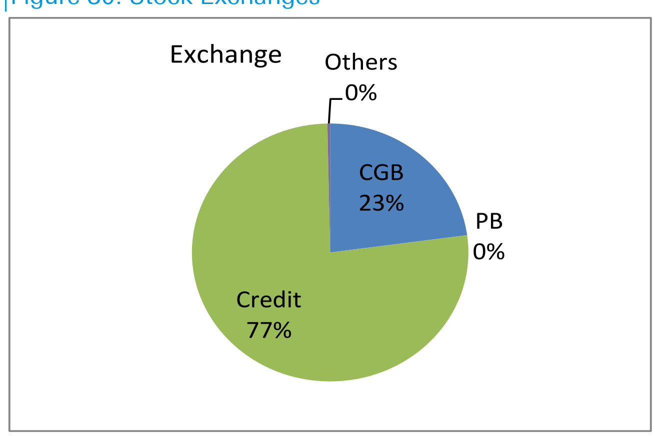
Source: Deutsche Bank, Chinabond

Figure 29: Offshore investors



Source: Deutsche Bank, Chinabond

Figure 30: Stock Exchanges



Source: Deutsche Bank, Chinabond

Foreign Exchange Strategy

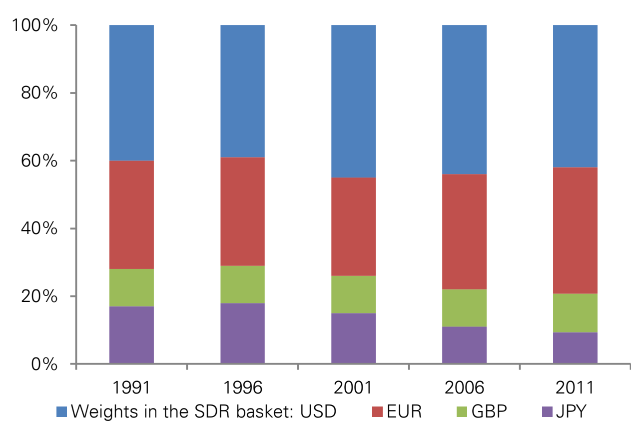
RMB: SDR inclusion

In recent weeks, Chinese policymakers have sent very strong signals regarding their desire to have the RMB added to the SDR basket. From an economic standpoint, we believe the RMB has fulfilled the necessary requirements – it is (1) widely used and (2) widely traded. Our economist estimates only a 40% probability of RMB inclusion with its full weight (which we estimate to be around 8%) this year. But we think a compromise could be to include RMB in the basket but at a smaller weight, or to pre-commit to including the RMB in the basket when hedging instruments are sufficiently developed. This should further encourage China to forge ahead with reforms and address some of the concerns we discuss below. Regardless of the outcome, we continue to expect China to push its reform agenda as we believe this initiative will encourage (1) further accumulation of RMB assets by global investors, and (2) more reforms within the domestic financial system.

What is the SDR?

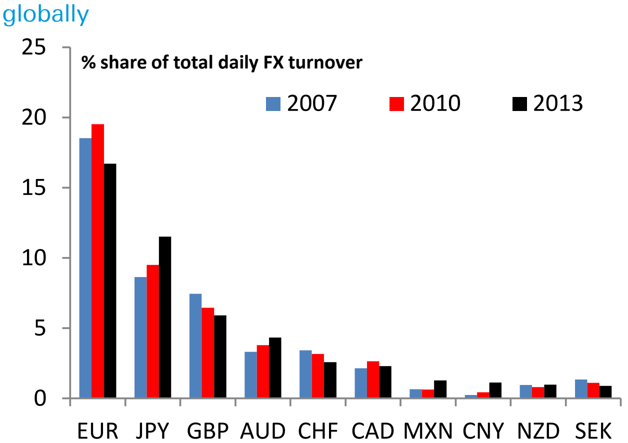
The SDR (special drawing right) is an international reserve asset created by the IMF in 1969. It was first defined as a claim – i.e., a drawing right – on the pooled reserves of the IMF member countries. The SDR was part of the 'SDR mechanism', devised to help support the Bretton-Woods (BW) fixed exchange rate system that was coming under increasing strain from rising BoP imbalances and a shortage of official reserves to address them within the constraints of a system of fixed exchange rates. The proposed solution was to replenish the level of official reserves by creating the SDR, which is a composite of the most commonly held reserve currencies. Currently, the SDR comprises a weighted basket of four currencies: USD (41.9%), EUR (37.4%), GBP (11.3%) and JPY (9.4%).

Figure 1: Weights of SDR basket since 1991



Source: Deutsche Bank, IMF

Figure 2: RMB is now the seventh-most traded currency globally



Source: Deutsche Bank, BIS

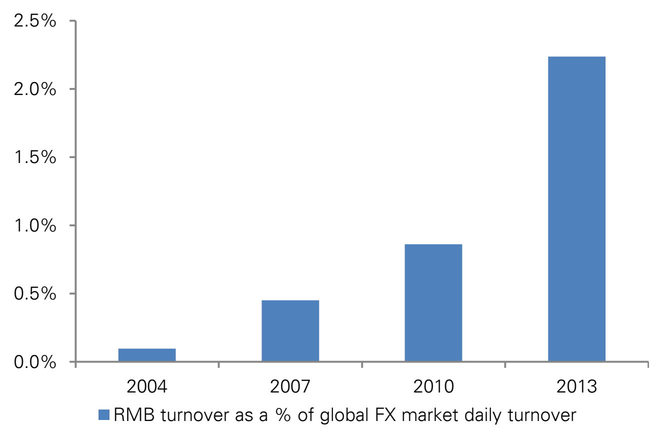
Requirements for SDR

According to the IMF, there are two necessary conditions that the RMB needs to meet to be eligible to join the SDR basket. It should be: (1) widely traded and (2) freely usable/widely used.

RMB has satisfied the first condition, in our opinion. The IMF's primary indicator of a widely traded currency is transaction volume. According to the BIS's triennial survey of the global foreign exchange market published in 2014, RMB turnover volume has increased dramatically and it is now the seventh-most traded currency globally (Figures 2 and 3).

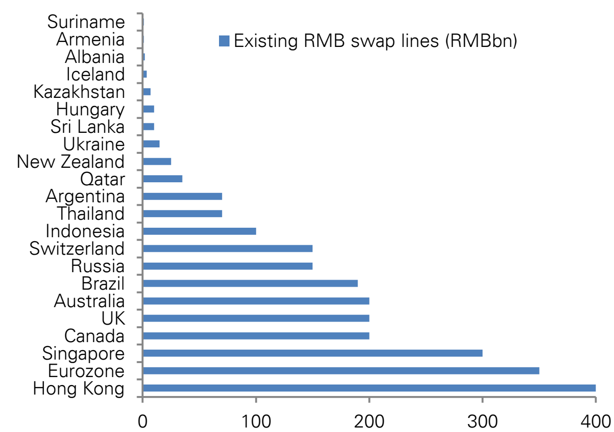
One of the counter-arguments to this is that RMB liquidity is still concentrated in Asia and to a much lesser extent Europe. RMB liquidity in the Americas, for example, remains poor, given the lack of RMB infrastructure such as an RMB clearing bank. However, we believe China is actively trying to address this issue. It is signing bilateral local currency swap-line agreements with various nations (Figure 4), has nominated a clearing bank in Canada and may do the same in Latin America.

Figure 3: RMB turnover volume globally is rising



Source: Deutsche Bank, BIS

Figure 4: China is signing more RMB swap lines with various countries



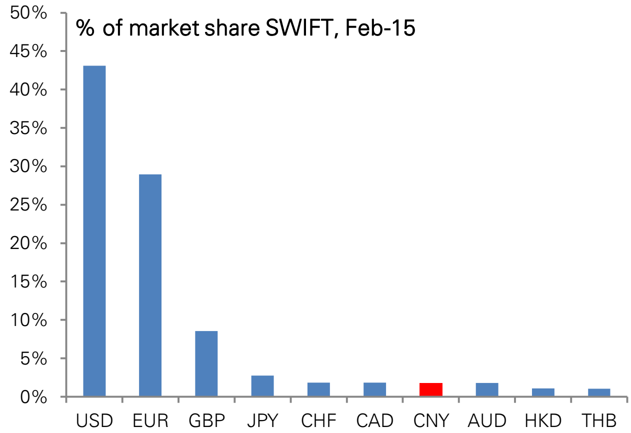
Source: Deutsche Bank, PBoC

Regarding the second condition of the currency being freely usable/widely used, it is first worth noting that 'freely usable' is not the same as 'fully capital account convertible'. For example, in the past, the GBP became part of the SDR basket despite not being fully capital account convertible. According to the IMF, the definition of a currency that is freely usable/widely used is:

- (1) it can be used to make payments for international transactions (both for current and capital account purposes); and
- (2) it is traded in key exchange markets. For the IMF, the key requirement here is that the currency has a deep and liquid market globally allowing the Fund to finance its operations freely.

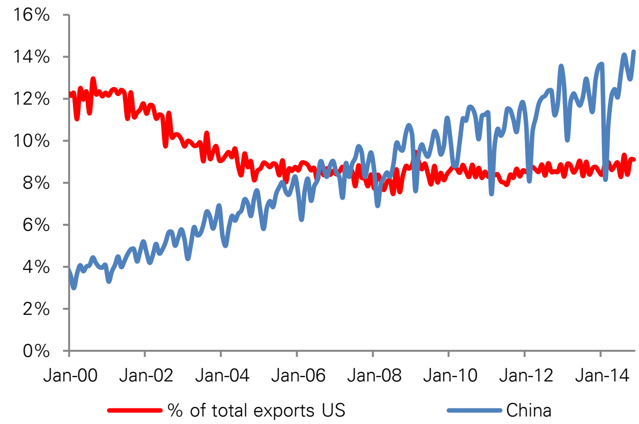
Regarding (1), according to SWIFT data, the RMB has become the seventh-most used currency for international payments (Figure 5) and the second-most widely used currency in trade financing. In addition, according to the IMF, China's share of exports relative to total world exports is rising steadily (Figure 6). Also, as of February 2015, about 25% of China's total trade was settled in RMB (Figure 7), and we expect this to grow. Compared to 2011, when the RMB was last reviewed for inclusion in the SDR basket, we think the evidence is clear that it meets these two criteria.

Figure 5: Seventh-most used currency for international trade payments



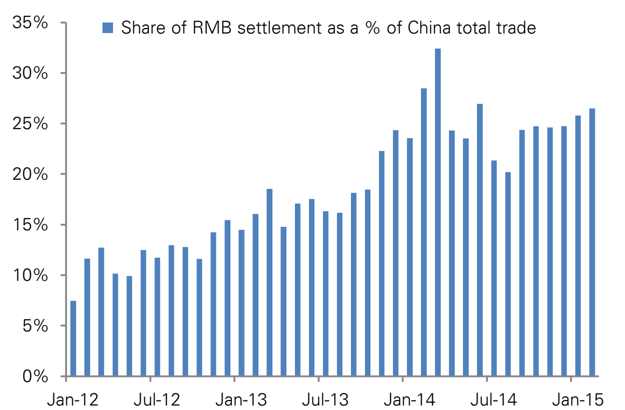
Source: Deutsche Bank, SWIFT

Figure 6: China's share of world exports



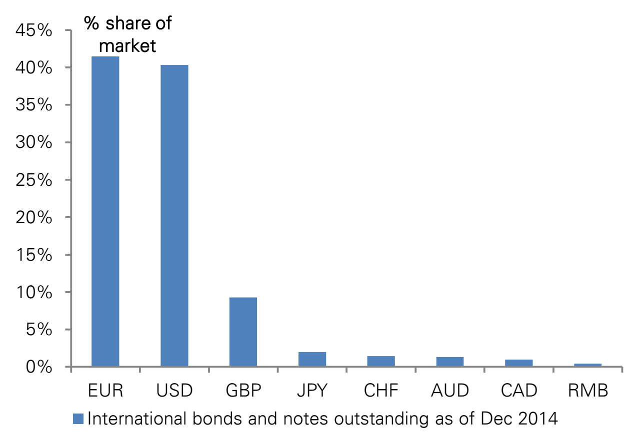
Source: Deutsche Bank, IMF, Haver analytics

Figure 7: About 25% of China trade is settled in RMB now, a significant improvement from 2011



Source: Deutsche Bank, CEIC

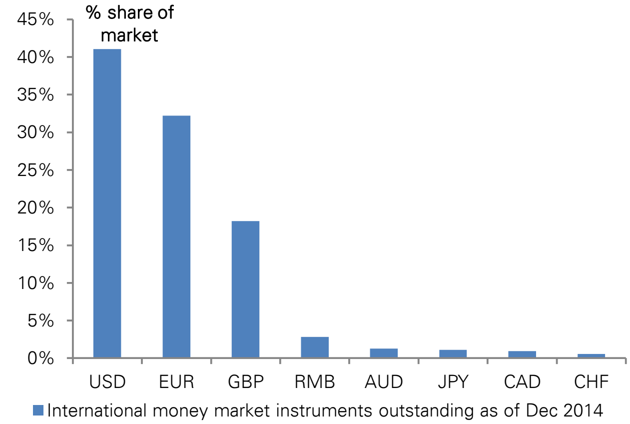
Figure 8: Although the amount of RMB-denominated bonds is still small in the international market…



Source: Deutsche Bank, BIS

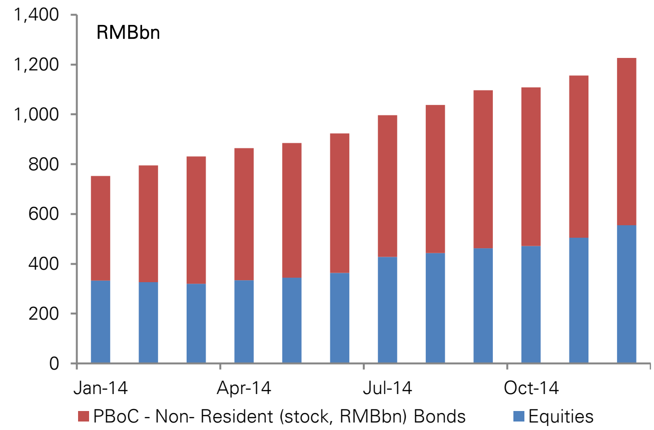
In terms of capital account transactions, global participants are increasingly issuing RMB-denominated debt. According to BIS data, although China's share of BIS-reported outstanding international bonds, notes and money market instruments is still small relative to the other four currencies in the SDR basket, it is gaining market share quickly. In fact, the RMB is now the fourth-most widely used currency for international money market instruments (Figure 9). In addition, we estimate foreign central banks are actively accumulating RMB assets. According to PBoC data, foreign ownership in China's equity and fixed income market reached RMB1.23trn at the end of 2014, close to double the level at the end of 2013 (Figure 10). We estimate about 40% of foreign ownership in China's capital market is represented by foreign reserve managers.

Figure 9: … RMB-denominated money market instruments are sizable and growing



Source: Deutsche Bank, BIS

Figure 10: Foreign ownership in China's capital market is rising notably

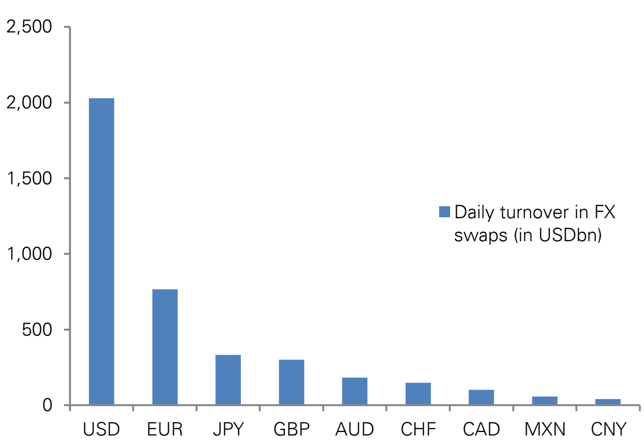


Source: Deutsche Bank, PBoC

Regarding condition (2), as highlighted above, given the swap lines China has opened with various countries, the ongoing improvement in RMB liquidity globally and China's ongoing creation of clearing banks including in Canada and possibly LatAm, we think the RMB satisfies this requirement in principle.

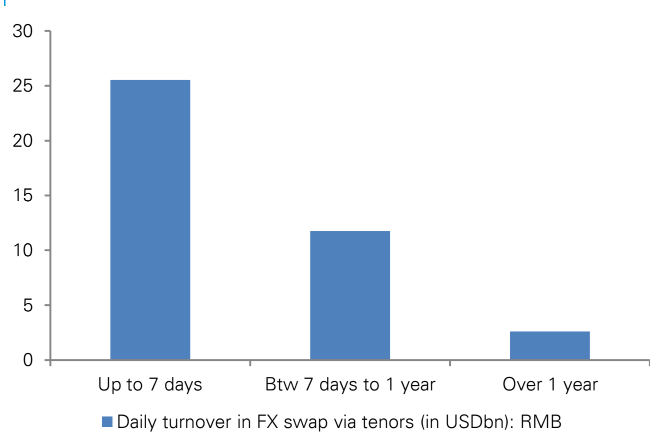
However, satisfying these two conditions may not be sufficient. We think the absence of a liquid international market for RMB hedging instruments may make inclusion of the RMB in the SDR basket difficult this time. As shown in Figure 11, unlike its G4 peers, RMB swap market liquidity is low, especially for long-dated instruments (Figure 12). On our estimates, the CNH cross currency swap market in Asian time zones has a daily turnover of around USD500-700m. However, the liquidity drops sharply to less than USD100m in European and US time zones. Hence from an operational perspective, the lack of a deep market for RMB hedging instruments currently may make it difficult for the IMF's member countries to risk-manage their RMB exposures appropriately. In fact, this was suggested as a possible criterion for future SDR candidates in the IMF paper published in 2011.

Figure 11: RMB FX swap markets remain small compared to G4 peers



Source: Deutsche Bank, BIS data as of April 2013

Figure 12: Majority of RMB swap liquidity sits at the short end of the curve



Source: Deutsche Bank, BIS data as of April 2013

So from an economic perspective we believe the RMB meets the necessary conditions to be included in the SDR basket. Indeed, IMF Managing Director Christine Lagarde has stated that “it's not a question of if, it's a question of when” the RMB will be added to the SDR basket. But the RMB market may not yet be ready for the RMB to be included on a technical basis.

Timeline and procedure

According to Reuters, the IMF board will hold an informal discussion in May on China’s request to join the SDR basket, while a formal review will be undertaken in October/November with a final decision announced in late November/December. The minimum vote required for RMB to join the basket is still unknown.

According to IMF Article XV, Section 2, *“The method of valuation of the special drawing right shall be determined by the Fund by a 70% majority of the total voting power, provided, however, that an 85% majority of the total voting power shall be required for a change in the principle of valuation or a fundamental change in the application of the principle in effect.”*

The key as to whether a 70% or 85% vote is required rests on whether the inclusion of RMB is considered just a valuation change or a fundamental change in the basket. If the latter is opted for, this would give the US more say in whether RMB should be included, as the US holds 16.7% of the IMF vote and has the right to veto the proposal.

Given there is still time before the formal discussions, we believe China will be more proactive in introducing reforms to increase its probability of joining the basket. This, in our view, includes: (1) accelerating basic RMB convertibility, (2) allowing more cross-border investments and foreign institutional investment into and out of China, (3) driving further FX reforms including widening the FX trading band from +/-2% to 3% or 4%, and (4) increasing the amount of swap agreements, including with more countries, to resolve concerns over RMB liquidity.

Probable weight

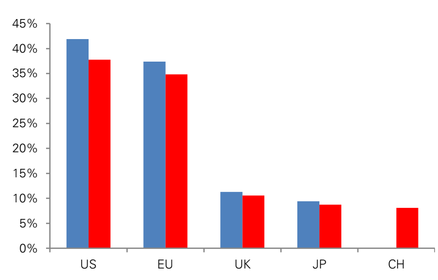
The current methodology the IMF uses to determine the weights of currencies in the SDR is the average value of reserve holdings in the SDR currencies and exports of goods and services over the five-year period preceding the review.

Following this methodology, we found it difficult to replicate the SDR weights provided by the IMF. This could be because the IMF does not publish China’s FX reserve allocation in its quarterly COFER data, which means we cannot apply the correct weights.

Nevertheless, using this approach and assuming the allocation of reserves in RMB is negligible over this period, we estimate the weight of the RMB would be around 8%.

Yet as mentioned due to the technical basis, we are skeptical the IMF will allow RMB inclusion with its full weight in the basket. As of now, the IMF’s current leading commitments would imply about RMB100bn of exposure by member countries would need to be managed. However, the current market liquidity may not fully allow that. Still, given Lagarde’s recent comment, we think the IMF is keen to send a positive message to China. So we think perhaps a compromise might be found using either the following arrangements:

Figure 13: RMB weight in the SDR could be around 8%



Source: Deutsche Bank, IMF

- (1) To include the RMB in the SDR basket with a lower weight and agree to raise the weight as RMB hedging products increase in liquidity and breadth.
- (2) The IMF may pre-commit to include the RMB when the availability and liquidity of RMB-denominated instruments are deemed to be adequate globally.

Implications

We believe there are several reasons China is pushing for inclusion.

- Inclusion of the RMB in the SDR basket will incentivize global central banks and investors to accumulate RMB. Although this may not automatically impact central banks' reserve allocation, allowing the RMB into the SDR basket will be seen as recognition of the RMB's potential as a reserve asset. As such, this should encourage global central banks and investors to accumulate more RMB assets.
- Chinese policymakers appear to expect that if the RMB is viewed as a reserve asset, then foreign investors will be more willing to invest in RMB-denominated assets. Since China is a net creditor to the rest of the world, the growing foreign interest in RMB will gradually cause more products to be priced in RMB, helping Chinese corporates to reduce currency risk from a transaction standpoint.
- It will encourage more reforms within the domestic system. Inclusion of the RMB will put pressure on China to: (1) keep opening up its capital account, (2) develop its domestic financial markets, and (3) have more market-driven, transparent and stable macroeconomic policies.

Credit Strategy

The tug of war

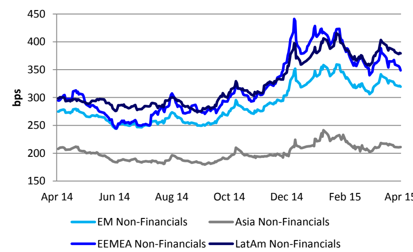
We look at the fundamentals for Asian corporates and banks in detail in this edition of our monthly post the just concluded results season. The tug of war between fundamentals vs. technicals continues in our space. While fundamentals are still deteriorating, technicals remain firm. The latter is winning for now and we don't see that changing in the near term. Spreads are grinding tighter and total returns in 1Q were just above 2%. April has also been a good month so far in line with history - in the past eight years since 2007, the returns in April have been positive in seven of them, with the only small negative being 2011 - average April return is around +1.3%. However, May has historically been very mixed for Asia credit - of the past eight years, returns were positive in four and negative in the other four - average May returns though are still positive at +0.4%, mainly driven by large +4% in 2011, and if we exclude 2011, then, average is slightly negative at -0.1%. One could argue that end of the day it is all about valuations and that fundamentals & technicals are secondary. As for valuations, spreads here are close to YTD tights, though still about 20bp and 100bp off the 2014 tights. We don't think they will go to last year's tights, though could have some more legs. Also, in a global context, Asia remains expensive, but again, it's hard to see catalysts for change. We retain our largely neutral stance on the asset class with a slight bias for IG over HY and Sovereigns over Corporates. We won't be surprised to see HY keep outperforming in the immediate future, but refrain from making frequent changes to our strategy given the relatively illiquid HY market. If anything, we recommend taking profits in HY in this rally. We have also cut down our HY buy recommendations to a bare minimum.

Fundamentals

The latest earnings season provided enough insights into this and we can emphatically say that things are worsening almost across the board, especially in China. We discuss the more relevant sectors in detail later in the report, but cash flows and credit metrics have deteriorated in general. The silver lining is that management are focused on the balance sheet and are cutting down capex & dividends along with raising the odd equity. However, this won't prevent the trend of negative rating actions outweighing the positive ones from continuing in our view, except for sovereigns, as witnessed by Moody's change of India's and Korea's outlook to positive last week. In fact, S&P released a report last week suggesting that the cushion for downward rating triggers is declining even for Indonesian corporates. In terms of sectors, the commodity space has been the worst impacted to no surprise, followed by real estate.

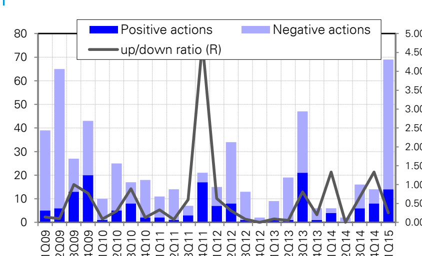
Separately, we continue to grapple with headline risks in the HY market with Sound Global being the latest casualty as its auditors suspended work on the back of some undisclosed issues. China also saw its first local bond default as Cloud Live Technology failed to pay principal at maturity, albeit it seems the company still has 30 days grace period, and this news was perhaps over shadowed by China's support for the local government debt through the RMB1 trillion debt swap & allowing NSSF to invest in local bond market. EMFX weakness and the consequent negative impact on credit profiles continue to lurk in the background, so is the weakening trend in quality of HY bond covenants. We have seen quite a few examples recently of companies doing consent solicitations to bring their old bond covenants in line with the new bonds. Having said all this, we do acknowledge that default rates are still low.

Figure 31: EM vs. Asia vs. EEMEA vs. LATAM spreads



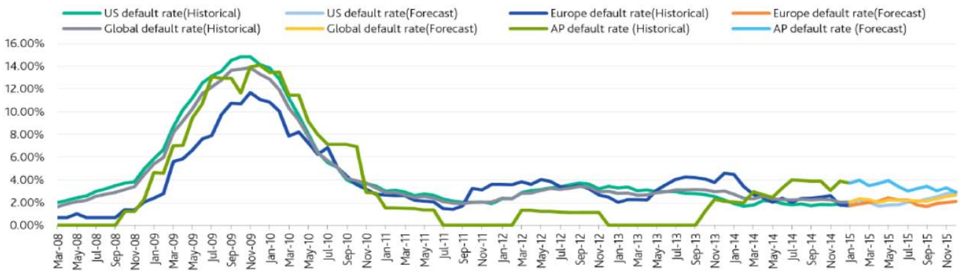
Source: Deutsche Bank, Markit iboxx

Figure 32: Upgrades to Downgrades Ratio



Source: Bloomberg Finance LP. Note we have considered Moodys ratings and these include ratings given by Moodys for all types of debt.

Figure 33: Moody's Trailing 12-Month Non Financial Corporate High-Yield Default Rate



Source: Moody's Investors Service. AP - Asia Pacific

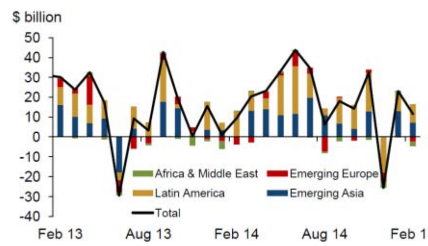
Technicals

Poor March NFP was almost the last nail in the coffin for experts forecasting a June rate hike by the Fed, though the subsequent FOMC meeting notes revived some of the hawks. Our own house view has been pushed back to September and there are certainly downside risks to even that. With disinflation still the theme, some European sovereign bond yields staying negative, interest rates low in the developed world, and most of Asia cutting rates, spread products are in demand. Fund flows continue to be positive and the great rotation from fixed income to equities remains elusive. If anything, the rally in equities, particularly in China (because of further loosening expectations and SOE reforms) is helping sentiments in credit. The equity rally has been supported by the M&A binge with ytd volumes up 22% yoy.

Further helping technicals is the fact that dealer inventory is light, overall supply has been in line with expectations (though lighter on the HY side) and companies are buying back bonds. April is a seasonally strong month for supply as companies come off the results blackout in Asia - the month has accounted for ~15% of the annual supply on average since 2009 (20% in 2014) - but returns have still been strong as mentioned before. And supply in April this year has been disappointing at a meagre USD4 billion at the time of writing. Even if it picks up, there is enough money to be put to work. This is also evidenced by the growing number of private placements at levels tighter than secondary markets. Separately, we are witnessing new investors come to our market as Europeans hunt for yield given QE there and insurance companies look to meet their yield targets. Even PB investors have been selling their Latam & Russia exposures to add to Asia. With syndicated loan volumes down more than 50% yoy in 1Q'15, some commercial banks are likely getting more involved in our market.

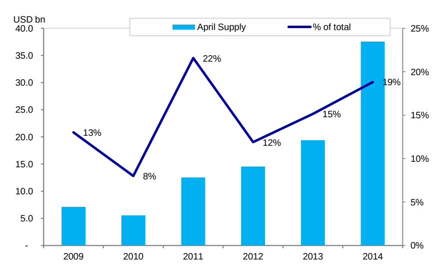
Oil has also played a helping hand and has been amazingly range bound (albeit very volatile within the range), defying bears that were expecting a crash to USD20-30 levels. So have Greece and Russia, managing to keep Grexit and Ruble crash at bay, respectively, at least for now. However, one of our key concerns on the technical side remains geopolitical headlines.

Figure 34: Portfolio Inflows to EMs



Source: IIF

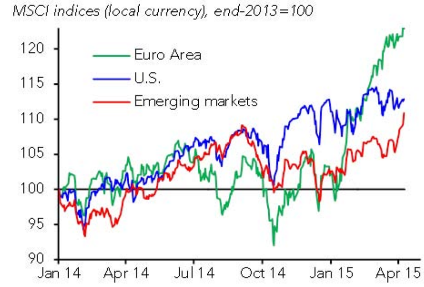
Figure 35: Historical supply in April



Source: BondRadar, Deutsche Bank

Figure 36: Global Equities

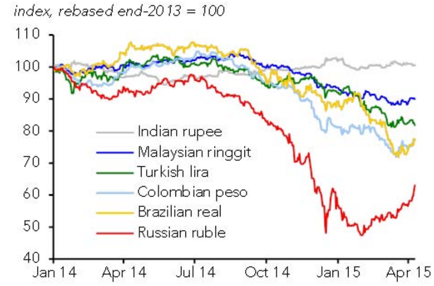
MSCI indices (local currency), end-2013=100



Source: IIF

Figure 37: Selected EM Currencies

index, rebased end-2013 = 100



Source: IIF

Financials

Figure 38: Financial peer summary of Chinese banks

USD million	ICBC Ltd.		China Constrn. Bank		Agri. Bank of China		Bank of China		Bank of Comm'ns.	
	2H13	2H14	2H13	2H14	2H13	2H14	2H13	2H14	2H13	2H14
Total Assets	3,124,680	3,345,772	2,537,570	2,718,203	2,405,249	2,593,206	2,291,644	2,475,874	984,579	1,017,581
Net Loans	1,599,097	1,748,174	1,381,062	1,497,226	1,140,102	1,256,493	1,228,836	1,346,549	527,404	544,608
Customer Deposits	2,414,949	2,525,422	2,018,902	2,093,941	1,950,913	2,034,642	1,667,870	1,767,082	690,823	660,433
Gross Loans % Deposits	67.9%	70.9%	70.3%	73.5%	61.2%	64.6%	75.3%	77.9%	78.1%	84.4%
Liquid assets ratio	28.5%	28.3%	26.5%	26.2%	30.3%	31.7%	30.8%	28.7%	29.5%	28.5%
Gross NPLs % Gross Loans	0.94%	1.13%	0.99%	1.19%	1.22%	1.54%	0.96%	1.18%	1.05%	1.25%
LLR % Gross NPLs	257.2%	206.9%	268.2%	222.3%	367.0%	286.5%	229.4%	187.6%	213.7%	178.9%
LLP % Pre-prov. Inc	9.4%	16.4%	17.9%	23.1%	24.4%	28.8%	8.4%	15.9%	22.3%	21.4%
Net Interest Income	72,108	79,472	63,359	70,434	61,189	69,226	46,125	51,707	21,251	21,703
Pre-provision Inc. (PPI)	60,954	67,018	52,528	58,092	43,454	48,346	38,254	44,853	15,955	16,950
Net Income	42,720	44,414	34,914	36,688	27,051	28,899	25,521	27,310	10,132	10,604
Net Interest Margin	2.57%	2.66%	2.74%	2.80%	2.79%	2.92%	2.24%	2.25%	2.52%	2.36%
Tier-I CAR	10.57%	12.19%	10.75%	12.12%	9.25%	9.46%	9.70%	11.35%	9.76%	11.30%
Total CAR	13.12%	14.53%	13.34%	14.87%	11.86%	12.82%	12.46%	13.87%	12.08%	14.04%

Source: Deutsche Bank, Company reports

As Chinese economy goes through the stage of a great adjustment and unprecedented reforms, it is unsurprising to see that the financial results for FY2014 of Chinese banks in 2H14 were characterised by worsening asset quality and moderation in loan growth. At the same time, the liquidity conditions in China remain quite good and all banks managed to strengthen their capital position. On a relative basis, out of the largest five banks we analyse, Bank of Communications performed the worst as interest rate liberalization caused a 4.4% YoY decline in deposits and 16bps YoY compression of NIM. CCB on the other hand reported strongest fundamental trends with one of the highest loan loss provisioning rates (LLR ratio stood at 222.3%) while it also strengthened its T1 capital to above 12%.

Loan growth for the five largest banks corrected sharply from 22.5% YoY at end of 2013 to 8.2% YoY at end of 2014 owing to the decline in loan demand from key industries as well as SMEs. This contributed to a slower growth of 9.8% in 2014 NII compared to 10.7% in 2013. The loan growth in China is unlikely, in our view, to accelerate materially despite the ongoing policy easing. This is mostly driven by the fact that many banks (e.g. BoChina, BoCom etc.) are already operating close to the maximum LDR of 75% allowed by the regulators. Hence their RMB loan growth is more dependent on RMB deposit collection pace, and not on the freed-up cash from RRR cuts.

NIM increased marginally by 3bps on an average in 2014 compared to previous year; however it declined by 16bps for BoCom due to faster rate of deposits accumulation and an initial impact from interest rate cuts. Non-Interest Income grew at 6.6% supported by investment gains from the rallying bond and equity markets. The deposit insurance scheme which will be launched on May 1, 2015 could diminish the advantage enjoyed by China's largest banks in attracting deposits on the back of having an implicit state guarantee. Further deregulation of deposit rates would motivate the larger banks to tackle resulting competition from smaller banks by increasing deposit rates thereby increasing cost of funds, although this would be limited to smaller retail deposits in our view.

As expected, gross NPLs for the five largest banks increased by ~ 20bps from 1.0% at end of 2013 to 1.3% at end of 2014 on average. Loan loss provisioning reserves dropped from 267.1% a year ago to 216.5% as banks utilized the government policy on bulk disposal of non-performing loans and to increase amounts written-off. We note that LLR cover of NPLs for the Chinese banks remains one of the highest in Asia and arguably in the wider EM too. Average T1 capital ratio improved to 11.3% from 10.0% at end of 2013 and total capital ratio increased to 14.0% from 12.6% in the same period led by both preferred stock and T2 bond issuances, reduced asset growth and capital replenishment from profits.

Looking forward, earnings growth of Chinese banks in 2015 should soften further led by the faster re-pricing of loans than deposits capturing lower policy rates. A moderation in economic growth will continue to exert downward pressure on asset quality, credit growth as well as non-core businesses. However we still maintain positive view on Chinese banks as they are well capitalized to withstand higher provisioning and reduced profit accretion to capital. Most banks have cut dividend payout ratios to improve capital retention too.

Bond strategy: We have maintained our positive stance on China's financial bond spreads for the past several months. Although banks, AMCs and brokers' bonds have remained mostly range-bound between Nov-14 and Feb-15, the spreads have rebound southward starting late Feb-15. Bond spreads of Chinese banks have tightened ~20bps between then and late March, and have remained mostly flat since then. BOCOM '19s tightening by 10bp YTD looks quite weak vs. the outperformance by AMC's and brokers with their bond spreads tightening anywhere between 30 and 60bp YTD. Despite their slowly worsening fundamentals (which was expected), we believe Chinese banks are well placed compared to Indian banks to withstand any credit cost blows. Unless the new issuance overwhelms (which is unlikely) the spreads would slowly grind tighter in the immediate future.

We welcome the relative underperformance of late of CITICS and HTISEC bonds vs. AMCs and maintain our view that this trend should continue. Amongst AMCs – we favour HRAM '20s and ORIEAS '24s (issued in Aug-14 and having rallied by ~50bp YTD the latter is trading only ~10bp tighter vs. re-offer level z-spread-wise, while HRAM '25s issued in Jan-15 has already rallied by ~85bp from re-offer). Amongst bank bonds, we continue to put more weight on Basel III T2 bonds issued by BCHINA and BOCOM, while reluctantly (i.e. respecting the strong technicals) we maintain Buys on BOCOM '23s and on ICBCAS '21s. We maintain our view that AT1 prefs issued by ICBC and Bank of China are expensive.

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China IG Corps: FY14 earnings season takeaways

Aggregate China IG corporate credit trends were a smidgen weaker in FY14 but overall we would characterize them as being steady. Gross leverage went up to 2.2x from 2.1x. Interest cover fell from 13.6x to 12.9x. Mild deterioration but still acceptable, in our view. What is perhaps more interesting is the split between 1H and 2H of 2014. Indeed it was a year of two halves where if the year had ended in June 2014, China IG credit trends would have actually improved. The weakness in 2H14 was driven by various factors so it is difficult to generalize across sectors. Oil names were hurt by the Q4 sell off in Brent. Consumer staples like Tingyi also reported a slowdown in Q4. Commodity related names suffered from falling ASPs. Gas utilities margins were affected by the delay in passing through price hikes. In reality China macro did slow down into year end. There are some good news for credit though. China Internet continues to be the bright spot and the challenging operating conditions have also forced many to increase to focus on cost and cash flow management.

Figure 39: Key Financials for China IG Corps

Income Statement	FY12	FY13	1H14	2H14	HoH	FY14	YoY
	RMBm	RMBm	RMBm	RMBm		RMBm	
Total Revenues	6,794,380	7,254,853	3,547,054	3,772,341	6.4%	7,319,395	0.9%
Gross Profit	695,621	736,306	405,160	345,458	-14.7%	750,617	1.9%
EBITDA	743,557	792,188	442,254	376,456	-14.9%	818,710	3.3%
Interest Expense	-49,919	-58,086	-33,457	-30,116	-10.0%	-63,573	9.4%
Balance Sheet	**FY12**	**FY13**	**1H14**	**2H14**	**HoH**	**FY14**	**YoY**
Cash	450,946	467,804	544,472	509,838	-6.4%	509,838	9.0%
Short Term Debt	575,915	741,530	772,979	725,395	-6.2%	725,395	-2.2%
Total Debt	1,347,311	1,636,181	1,788,157	1,764,677	-1.3%	1,764,677	7.9%
Net Debt	896,365	1,168,377	1,243,685	1,254,839	0.9%	1,254,839	7.4%
Total Capitalization	3,979,212	4,544,998	4,833,109	4,873,763	0.8%	4,873,763	7.2%
Credit Ratios	**FY12**	**FY13**	**1H14**	**2H14**	**HoH**	**FY14**	**YoY**
Gross Margin	10.2%	10.1%	11.4%	9.2%		10.3%	
EBITDA Margin	10.9%	10.9%	12.5%	10.0%		11.2%	
EBITDA/Interest Expense	14.9x	13.6x	13.2x	12.5x		12.9x	
Total Debt/EBITDA	1.8x	2.1x	2.0x	2.3x		2.2x	
Net Debt/EBITDA	1.2x	1.5x	1.4x	1.7x		1.5x	
Total Debt/Total Capital	33.9%	36.0%	37.0%	36.2%		36.2%	
Cash/ST Debt	78.3%	63.1%	70.4%	70.3%		70.3%	

Source: Deutsche Bank, company data
Note: Companies include Oil & Gas (Sinopec, CNOOC, Petrochina), Gas utilities (Beijing Enterprises, CR Gas, ENN), Food & Beverage (Tingyi, Mengniu), Construction (China Railway Group, China Railway Construction, China Oilfield Services, Chalieco), Metals & Mining (Chalco, Baosteel, Yanzhou), China Internet (Baidu, Tencent).

Taking a closer look we find FY14 being mixed depending on which sectors we look at. Not surprisingly cyclically driven sectors were generally weaker than consumer related names. We look at 6 sector groups namely Oil & Gas (O&G), Gas Utilities, Metals & Mining (M&M), Food & Beverage (F&B), Construction and China Internet. We then evaluate and rank the sectors by 7 key metrics: 1) revenue change, 2) EBITDA change, 3) change in total debt, 4) change in EBITDA margin, 5) change in gross leverage, 6) change in gearing (debt/capital), and 7) change in liquidity position. We assign a score for each metric to come up with an equally weighted overall ranking of sectors.

Our analysis suggests that F&B fared the best in FY14, followed by Construction, O&G, China Internet, Gas Utilities and lastly M&M. The F&B sector benefitted from China Mengniu's recapitalization effort last year while Construction firms are reaping the rewards from focusing on cash flow generation via stronger working capital management. Interestingly O&G names were reasonably stable as the Brent sell-off only really affected Q4 performance while cost management was generally stronger. We think the real test though for the sector would be in 1H15 though (more on outlook below). China Internet names are still enjoying strong earnings growth but they were also most aggressive in debt raising. Gas utilities were partly affected by the delay in gas price pass-through but also reduced dependency on higher margin connection fee income. Not surprisingly, M&M names fared the worst due to weaker ASP prices. We show the results and ranking of the 7 metrics in Figure 12 and 13 below. We also show the aggregate financials and credit ratios for each individual sectors in Figure 14 to 19.

Figure 40: Sector Ranking by 7 metrics

Metrics/sector ranking	Best ← 1	2	3	4	5	→ Worst 6
Revenue △	Internet	Gas utility	F&B	Construction	O&G	M&M
EBITDA △	Internet	F&B	Construction	Gas Utility	O&G	M&M
△total debt yoy	F&B	M&M	Construction	O&G	Gas Utility	Internet
△ebitda margin	F&B	Construction	O&G	Internet	Gas Utility	M&M
△gross leverage	F&B	Construction	O&G	Internet	Gas Utility	M&M
△debt/capital	F&B	Construction	O&G	M&M	Gas Utility	Internet
△cash/ST debt	F&B	M&M	O&G	Construction	Gas Utility	Internet
Overall	F&B	Construction	O&G	Internet	Gas Utility	M&M

Source: Deutsche Bank, company data

Figure 41: Results by sector

Metrics	Oil & Gas	Gas utility	Food & Beverage	Construction	Metals & Mining	China Internet
Revenue △yoy (%)	-0.8%	20.3%	14.6%	5.8%	-6.2%	38.5%
EBITDA △yoy (%)	1.1%	14.0%	34.2%	14.9%	-19.8%	38.6%
△total debt yoy (%)	7.3%	28.6%	-14.0%	3.8%	0.8%	87.9%
△ebitda margin (by percentage points)	0.2%	-0.7%	1.3%	0.5%	-1.2%	0.0%
△gross leverage (by x)	0.1x	0.5x	-1.3x	-0.5x	1.8x	0.3x
△debt/capital (by percentage points)	0.5%	3.8%	-10.1%	-3.4%	1.1%	6.2%
△cash/ST debt (by percentage points)	5.2%	-159.3%	19.2%	-5.6%	8.6%	-1437.7%

Source: Deutsche Bank, company data

Sector financial analysis

- **Revenue and EBITDA trend**: We note that 2H tends to be seasonally a stronger period for many sectors so we'll focus on FY14. On a full year basis, aggregate revenues were marginally negative for O&G (-1% yoy) and meaningfully weaker for M&M (-6% yoy) but higher across the other four sectors (Gas utilities, F&B, Construction, and China Internet). Both Oil & Gas revenues and Metals & Mining were affected by lower ASPs although the former to a lesser extent as Brent was fairly well supported throughout the year prior to the selloff in Q4. Despite the softness in revenue, O&G EBITDA actually rose 1% due to better cost control. Indeed aggregate EBITDA were up across all sectors except for M&M (which fell 20%). M&M ranked the worst in terms of revenue and EBITDA performance whilst China Internet ranked the best.

- **Margin performance**: A mixed bag here with M&M and Gas Utility EBITDA margins compressing by 120bps and 70bps respectively in FY14. Lower ASPs were the main driver for the former whilst the latter was affected by a delay of pass-through and income mix (ie lower dependence on higher margin connection fee income). F&B margins expanded the most (by 130bps) on lower raw material costs but also good SG&A cost discipline.

- **Cash flow performance:** Not all companies have disclosed their cash flow performance for the year. But for those who have, full year aggregate operating cash flows were stronger across the board. For the record O&G, Construction, M&M, and China Internet OCF were up 12%, 608%, 155%, and 33%, respectively. We were particularly encouraged to see a stronger focus on working capital management to improve OCF by Construction and M&M firms. The operating cash flows for China Internet was primarily underpinned by strong earnings growth.

- **Credit ratios:** Gross debt levels were higher across the board except for F&B (-14% yoy) and M&M (flattish). The debt reduction in F&B was largely driven by China Mengniu's equity raise. For the M&M sector, gross debt levels would have been lower if not for Yanzhou Coal (as Chalco and Baosteel debt levels actually fell yoy). In terms of financial leverage, the combination of earnings growth and debt reduction drove F&B sector gross leverage down from 3.6x to 2.3x in FY14. Faster earnings relative to debt growth also helped drive Construction sector leverage lower to 5.0x from 5.6x. Not surprisingly, M&M leverage deteriorated the most, up from 7.0x to 8.8x in FY14. For China Internet, it is worth noting that whilst the sector remains in net cash, it has been in balance sheet optimization mode. Gross Debt/Capital ratio rose by 6.2ppts in FY14 for China internet – the most across the 6 sectors covered here whereas gearing remains largely unchanged for O&G and M&M.

- **Near term outlook is mixed - China Internet (+), O&G (-), M&M (-), Gas utilities, F&B, Construction (=):** We think the near term outlook remains challenging for **O&G and M&M** largely given ASP weakness. Brent is averaging about 38% lower to date relative to 2H14 average so the real test will be its 1H15 results. Refiners like Sinopec should outperform has Brent has been fairly range-bound (albeit at lower levels) while CNOOC and Petrochina should feel more pain given their larger exposure to E&P. The good news though is the sector is in cash preservation mode right now with lower capex and stronger focus on cost set in sight for 2015. In M&M, relative to FY14 average we note that 2015 YTD average prices for China thermal coal, China coking coal, Australia thermal coal, and Australia coking coal are 6%, 10%, 9% and 7% lower, respectively. Chinese HRC and Rebar average price this year is around 20% and 18% lower than FY14 average. Lower spot iron ore should provide some offset for Baosteel though. Away from these cyclically driven sectors, we believe the year has not started strongly for **Gas utilities and F&B** given the slower China macro. Policy easing is expected to kick start demand but we believe any meaningful improvement will likely only feed through later this year. Offsetting this we can expect ongoing product mix improvement and low material cost to continue to benefit F&B names. **Construction** firms may continue to benefit from railway/urbanization related investments but 1H has generally been seasonally a softer period for cash collection so this may translate into higher debt levels in the interim although we note that the sector will likely remain very focused on debt/cash flow management in FY14. Structurally the earnings outlook appears most favorable for **China internet**. While we expect the sector to remain in net cash, M&A/investment needs will likely continue to underpin funding needs going forward.

Bond market reaction

On average, all sectors (except for O&G) have outperformed the market over the last month or so. Average sector spreads for China Internet, F&B, Gas Utilities, M&M and Construction are 10bp, 8bp, 5bp, 8bp and 4bp tighter since beginning of March, respectively. Broader Asia IG corporate spreads are about 3bps tighter. China O&G sector spreads are 3bp wider over the same period although that comes after a nearly 50bp compression since the January wides. Overall there appears to be little correlation between their respective results and spread performance. This is not surprising for IG in our view. Rather we believe spread performance to date has been largely driven by technicals given the fairly underwhelming supply from China IG corporates so far.

IG Corp Strategy

We think China IG fundamentals still have room to deteriorate in the near term. 1H15 will be the real test for many (especially commodity related names) given lower ASP comps. Expected policy easing (and ongoing rally equities) may drive sentiment but we think it will take some time before fundamentals improve on stronger demand. We expect any fundamental recovery to likely be more visible later this year. Valuations are not brilliant with most names trading near their tights but technicals are supportive. China IG corp supply has underwhelmed to date and we see few reasons why the trend will continue. Firms are not investing as much these days with many scaling back in capex.

From a liability management angle US Dollar is not an appreciating currency as oppose to a deprecating story that it was few years back. Instead EUR seems to be on corporate treasurers' radar screen given yields and the currency outlook. Onshore CNY yields have also compressed against USD yields. Finally bank loans and private placements are competing sources of funding. Against this backdrop, we think technicals have more legs as long as US rates volatility remain contained. We are respectful of the technicals are reluctant to be underweight China IG despite valuations. Credit selection as always will remain key.

We upgrade our view on China O&G belly to Neutral and revise our Sell recommendations on select bonds to Hold. China Oil belly still offers long term value against DM peers but more importantly relative value against Malaysian peers will likely continue to support current valuations. China oil now trades 25bp wider than Malay comp which we think is too wide. Along China Oil curve we still prefer the 30yr and select bonds along the 5yr part of the curve.

Away from China, we still like HK corporates given solid technicals (due to lack of supply) and steady fundamentals. As we've written before India corporates are not cheap but for choice we still prefer corps over financials. We maintain our preference for long dated RILIN bonds given the steepness of the 10s/30s curve. Recent regulatory developments around ECB may prompt further IG issuance but we think there is enough demand on the sidelines for more supply (especially following the recent outlook change by Moody's to positive). Korea is tight and we see little value but fundamentals are being supported post Moody's recent outlook change to Positive. But technicals remain very supportive as evidenced by recent new issue performance.

Picks: CITPAC (2018, 2020, 2023, 7.875% perp), CNPCCH'19, CNPCCH'41, SINOPE'42, BABA'34, CHMEDA'18, RLCONS'49, CHPWCN'49, SUNHUN'24c19, HLPPY (2021, 2022), NOBLSP'20, HUWHY'24, LIHHK'17, BHARTI'21 (EUR), RILIN (2022, 2040, 2045).

Pans: CNOOC'18, COFCO'18, COSL'22, SECGRP'19, GERGHK'23, KOROIL'24

Recommendation change: Upgrade to Hold from Sell SINOPE'22, CNPCCH'22, CNPCCH'23, Downgrade to Hold from Buy SINOPE'17.

Please refer to Figures 42-43 for the comprehensive list of trade recommendations, rationale and risks.

Figure 42: Key Financials for Oil & Gas

Income Statement	FY12	FY13	1H14	2H14	HoH	FY14	YoY
	RMBm	RMBm	RMBm	RMBm		RMBm	
Total Revenues	5,228,968	5,424,292	2,648,940	2,734,570	3.2%	5,383,510	-0.8%
Gross Profit	497,558	498,303	276,161	194,941	-29.4%	471,102	-5.5%
EBITDA	613,638	642,380	358,762	290,912	-18.9%	649,674	1.1%
Interest Expense	-30,984	-37,140	-20,996	-18,315	-12.8%	-39,311	5.8%
Cash Flow	**FY12**	**FY13**	**1H14**	**2H14**	**HoH**	**FY14**	**YoY**
Operating Cash Flow	474,242	551,313	247,527	367,805	48.6%	615,332	11.6%
Investing Cash Flow	-558,220	-615,282	-224,449	-289,199	28.8%	-513,648	-16.5%
Financing Cash Flow	78,400	37,881	23,969	-109,188	-555.5%	-85,219	-325.0%
Net Cash Change	-5,578	-26,088	47,047	-30,582	-165.0%	16,465	-163.1%
Balance Sheet	**FY12**	**FY13**	**1H14**	**2H14**	**HoH**	**FY14**	**YoY**
Cash	129,023	112,887	153,196	124,933	-18.4%	124,933	10.7%
Short Term Debt	296,059	406,478	431,238	378,456	-12.2%	378,456	-6.9%
Total Debt	781,005	936,941	1,005,100	1,005,072	0.0%	1,005,072	7.3%
Net Debt	651,982	824,054	851,904	880,139	3.3%	880,139	6.8%
Total Capitalization	2,819,569	3,170,122	3,326,262	3,348,040	0.7%	3,348,040	5.6%
Credit Ratios	**FY12**	**FY13**	**1H14**	**2H14**	**HoH**	**FY14**	**YoY**
Gross Margin	9.5%	9.2%	10.4%	7.1%		8.8%	
EBITDA Margin	11.7%	11.8%	13.5%	10.6%		12.1%	
EBITDA/Interest Expense	19.8x	17.3x	17.1x	15.9x		16.5x	
Total Debt/EBITDA	1.3x	1.5x	1.4x	1.7x		1.5x	
Net Debt/EBITDA	1.1x	1.3x	1.2x	1.5x		1.4x	
Total Debt/Total Capital	27.7%	29.6%	30.2%	30.0%		30.0%	
Cash/ST Debt	43.6%	27.8%	35.5%	33.0%		33.0%	

Source: Deutsche Bank, company data
Note: Companies include Sinopec, CNOOC, Petrochina

Figure 43: Key Financials for Gas Utility

Income Statement	FY12	FY13	1H14	2H14	HoH	FY14	YoY
	RMBm	RMBm	RMBm	RMBm		RMBm	
Total Revenues	79,939	104,333	58,749	66,814	13.7%	125,562	20.3%
Gross Profit	19,463	25,550	13,968	13,864	-0.7%	27,833	8.9%
EBITDA	11,088	14,614	8,737	7,925	-9.3%	16,662	14.0%
Interest Expense	-2,272	-2,653	-1,254	-1,328	5.9%	-2,582	-2.7%
Cash Flow	**FY12**	**FY13**	**1H14**	**2H14**	**HoH**	**FY14**	**YoY**
Operating Cash Flow	13,535	18,908	11,373	NA		NA	
Investing Cash Flow	-18,646	-19,849	-6,727	NA		NA	
Financing Cash Flow	15,219	-2,068	-2,166	NA		NA	
Net Cash Change	10,108	-3,009	2,480	NA		NA	
Balance Sheet	**FY12**	**FY13**	**1H14**	**2H14**	**HoH**	**FY14**	**YoY**
Cash	34,823	32,472	34,562	36,827	6.6%	36,827	13.4%
Short Term Debt	15,293	11,177	12,698	28,061	121.0%	28,061	151.1%
Total Debt	62,684	62,338	62,640	80,138	27.9%	80,138	28.6%
Net Debt	27,861	29,867	28,077	43,312	54.3%	43,312	45.0%
Total Capitalization	151,797	178,296	183,508	206,799	12.7%	206,799	16.0%
Credit Ratios	**FY12**	**FY13**	**1H14**	**2H14**	**HoH**	**FY14**	**YoY**
Gross Margin	24.3%	24.5%	23.8%	20.8%		22.2%	
EBITDA Margin	13.9%	14.0%	14.9%	11.9%		13.3%	
EBITDA/Interest Expense	4.9x	5.5x	7.0x	6.0x		6.5x	
Total Debt/EBITDA	5.7x	4.3x	3.6x	5.1x		4.8x	
Net Debt/EBITDA	2.5x	2.0x	1.6x	2.7x		2.6x	
Total Debt/Total Capital	41.3%	35.0%	34.1%	38.8%		38.8%	
Cash/ST Debt	227.7%	290.5%	272.2%	131.2%		131.2%	

Source: Deutsche Bank, company data
Note: Companies include Beijing Enterprises, CR Gas, ENN

Figure 44: Key Financials for Food & Beverage

Income Statement	FY12	FY13	1H14	2H14	HoH	FY14	YoY
	RMBm	RMBm	RMBm	RMBm		RMBm	
Total Revenues	37,495	45,133	26,729	24,982	-6.5%	51,711	14.6%
Gross Profit	9,397	12,234	8,659	7,280	-15.9%	15,940	30.3%
EBITDA	2,707	3,319	2,273	2,183	-4.0%	4,455	34.2%
Interest Expense	-44	-166	-180	-168	-6.5%	-348	108.8%
Cash Flow	**FY12**	**FY13**	**1H14**	**2H14**	**HoH**	**FY14**	**YoY**
Operating Cash Flow	2,069	3,481	1,709	NA		NA	
Investing Cash Flow	-3,332	-15,397	-3,338	NA		NA	
Financing Cash Flow	-102	12,325	3,311	NA		NA	
Net Cash Change	-1,365	409	1,682	NA		NA	
Balance Sheet	**FY12**	**FY13**	**1H14**	**2H14**	**HoH**	**FY14**	**YoY**
Cash	5,887	7,302	8,929	4,840	-45.8%	4,840	-33.7%
Short Term Debt	680	8,719	5,449	4,703	-13.7%	4,703	-46.1%
Total Debt	840	12,062	10,485	10,370	-1.1%	10,370	-14.0%
Net Debt	-5,047	4,760	1,556	5,530	255.4%	5,530	16.2%
Total Capitalization	14,527	30,710	34,353	35,527	3.4%	35,527	15.7%
Credit Ratios	**FY12**	**FY13**	**1H14**	**2H14**	**HoH**	**FY14**	**YoY**
Gross Margin	25.1%	27.1%	32.4%	29.1%		30.8%	
EBITDA Margin	7.2%	7.4%	8.5%	8.7%		8.6%	
EBITDA/Interest Expense	60.9x	19.9x	12.7x	13.0x		12.8x	
Total Debt/EBITDA	0.3x	3.6x	2.3x	2.4x		2.3x	
Net Debt/EBITDA	-1.9x	1.4x	0.3x	1.3x		1.2x	
Total Debt/Total Capital	5.8%	39.3%	30.5%	29.2%		29.2%	
Cash/ST Debt	866.0%	83.7%	163.9%	102.9%		102.9%	

Source: Deutsche Bank, company data
Note: Companies include Tingyi, Mengniu

Figure 45: Key Financials for Construction

Income Statement	FY12	FY13	1H14	2H14	HoH	FY14	YoY
	RMBm	RMBm	RMBm	RMBm		RMBm	
Total Revenues	988,683	1,172,855	554,189	686,506	23.9%	1,240,695	5.8%
Gross Profit	100,396	115,340	55,995	74,549	33.1%	130,544	13.2%
EBITDA	55,414	63,543	34,157	38,857	13.8%	73,014	14.9%
Interest Expense	-10,537	-11,002	-6,213	-5,967	-4.0%	-12,181	10.7%
Cash Flow	**FY12**	**FY13**	**1H14**	**2H14**	**HoH**	**FY14**	**YoY**
Operating Cash Flow	7,985	4,977	-19,422	54,669	-381.5%	35,247	608.2%
Investing Cash Flow	-28,977	-35,913	-22,187	-21,847	-1.5%	-44,034	22.6%
Financing Cash Flow	40,701	18,584	35,158	-35,071	-199.8%	87	-99.5%
Net Cash Change	19,710	-12,351	-6,452	-2,249	-65.1%	-8,701	-29.6%
Balance Sheet	**FY12**	**FY13**	**1H14**	**2H14**	**HoH**	**FY14**	**YoY**
Cash	176,739	185,790	179,990	178,476	-0.8%	178,476	-3.9%
Short Term Debt	140,154	173,207	177,194	175,514	-0.9%	175,514	1.3%
Total Debt	277,206	354,557	398,583	368,049	-7.7%	368,049	3.8%
Net Debt	100,467	168,767	218,593	189,572	-13.3%	189,572	12.3%
Total Capitalization	475,928	578,813	639,058	635,887	-0.5%	635,887	9.9%
Credit Ratios	**FY12**	**FY13**	**1H14**	**2H14**	**HoH**	**FY14**	**YoY**
Gross Margin	10.2%	9.8%	10.1%	10.9%		10.5%	
EBITDA Margin	5.6%	5.4%	6.2%	5.7%		5.9%	
EBITDA/Interest Expense	5.3x	5.8x	5.5x	6.5x		6.0x	
Total Debt/EBITDA	5.0x	5.6x	5.8x	4.7x		5.0x	
Net Debt/EBITDA	1.8x	2.7x	3.2x	2.4x		2.6x	
Total Debt/Total Capital	58.2%	61.3%	62.4%	57.9%		57.9%	
Cash/ST Debt	126.1%	107.3%	101.6%	101.7%		101.7%	

Source: Deutsche Bank, company data
Note: Companies include China Railway Group, China Railway Construction, China Oilfield Services, Chalieco

Figure 46: Key Financials for China Internet

Income Statement	FY12	FY13	1H14	2H14	HoH	FY14	YoY
	RMBm	RMBm	RMBm	RMBm		RMBm	
Total Revenues	66,200	92,381	59,628	68,356	14.6%	127,984	38.5%
Gross Profit	41,544	53,131	35,876	42,350	18.0%	78,226	47.2%
EBITDA	30,238	34,385	22,519	25,144	11.7%	47,663	38.6%
Interest Expense	219	-53	68	169	148.3%	237	-547.3%
Cash Flow	**FY12**	**FY13**	**1H14**	**2H14**	**HoH**	**FY14**	**YoY**
Operating Cash Flow	31,425	38,167	21,553	29,095		50,648	32.7%
Investing Cash Flow	-30,019	-42,197	NA	NA		-50,856	
Financing Cash Flow	7,132	8,990	NA	NA		26,962	
Net Cash Change	8,538	4,960	20,028	20,582		26,754	
Balance Sheet	**FY12**	**FY13**	**1H14**	**2H14**	**HoH**	**FY14**	**YoY**
Cash	70,566	89,698	106,156	116,013	9.3%	116,013	29.3%
Short Term Debt	3,281	2,978	5,268	7,367	39.9%	7,367	147.4%
Total Debt	22,641	32,712	59,381	61,459	3.5%	61,459	87.9%
Net Debt	-47,925	-56,986	-46,775	-54,554	16.6%	-54,554	-4.3%
Total Capitalization	92,004	131,840	175,924	198,088	12.6%	198,088	50.2%
Credit Ratios	**FY12**	**FY13**	**1H14**	**2H14**	**HoH**	**FY14**	**YoY**
Gross Margin	62.8%	57.5%	60.2%	62.0%		61.1%	
EBITDA Margin	45.7%	37.2%	37.8%	36.8%		37.2%	
EBITDA/Interest Expense	-138.3x	647.7x	-330.3x	-148.6x		-200.7x	
Total Debt/EBITDA	0.7x	1.0x	1.3x	1.2x		1.3x	
Net Debt/EBITDA	-1.6x	-1.7x	-1.0x	-1.1x		-1.1x	
Total Debt/Total Capital	24.6%	24.8%	33.8%	31.0%		31.0%	
Cash/ST Debt	2151.0%	3012.5%	2015.3%	1574.8%		1574.8%	

Source: Deutsche Bank, company data
Note: Companies include Baidu, Tencent

Figure 47: Key Financials for Metals & Mining

Income Statement	FY12	FY13	1H14	2H14	HoH	FY14	YoY
	RMBm	RMBm	RMBm	RMBm		RMBm	
Total Revenues	393,095	415,859	198,818	191,114	-3.9%	389,932	-6.2%
Gross Profit	27,264	31,747	14,500	12,473	-14.0%	26,973	-15.0%
EBITDA	30,473	33,947	15,806	11,435	-27.7%	27,241	-19.8%
Interest Expense	-6,300	-7,071	-4,882	-4,507	-7.7%	-9,389	32.8%
Cash Flow	**FY12**	**FY13**	**1H14**	**2H14**	**HoH**	**FY14**	**YoY**
Operating Cash Flow	29,812	18,141	19,393	26,832	38.4%	46,225	154.8%
Investing Cash Flow	-22,930	-29,907	-9,985	-22,435	124.7%	-32,420	8.4%
Financing Cash Flow	-9,635	15,644	8,477	-13,289	-256.8%	-4,812	-130.8%
Net Cash Change	-2,754	3,878	17,885	-8,892	-149.7%	8,993	131.9%
Balance Sheet	**FY12**	**FY13**	**1H14**	**2H14**	**HoH**	**FY14**	**YoY**
Cash	33,909	39,656	61,639	48,749	-20.9%	48,749	22.9%
Short Term Debt	120,449	138,971	141,133	131,293	-7.0%	131,293	-5.5%
Total Debt	202,936	237,571	251,968	239,589	-4.9%	239,589	0.8%
Net Debt	169,027	197,915	190,329	190,840	0.3%	190,840	-3.6%
Total Capitalization	425,387	455,216	474,003	449,421	-5.2%	449,421	-1.3%
Credit Ratios	**FY12**	**FY13**	**1H14**	**2H14**	**HoH**	**FY14**	**YoY**
Gross Margin	6.9%	7.6%	7.3%	6.5%		6.9%	
EBITDA Margin	7.8%	8.2%	8.0%	6.0%		7.0%	
EBITDA/Interest Expense	4.8x	4.8x	3.2x	2.5x		2.9x	
Total Debt/EBITDA	6.7x	7.0x	8.0x	10.5x		8.8x	
Net Debt/EBITDA	5.5x	5.8x	6.0x	8.3x		7.0x	
Total Debt/Total Capital	47.7%	52.2%	53.2%	53.3%		53.3%	
Cash/ST Debt	28.2%	28.5%	43.7%	37.1%		37.1%	

Source: Deutsche Bank, company data
Note: Companies include Chalco, Baosteel, Yanzhou

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China HY Industrials

Key takeaways

- Results were generally weak, not surprisingly, as some of them had already announced profit warnings. From a credit perspective, commodity related names were the worst (Anton & Honghua, though MIE wasn't as bad), followed by infrastructure driven companies (Zoomlion, Shanshui, West China, China Automation) and department store operators (Maoye, Parkson). Metal & mining credits fared relatively better (China Oriental, Hongqiao, with the exception of Yingde Gas), while consumer sector corporates were the best (Fufeng, Texhong, Hengdeli, Geely, Car Inc., CHIOIL). Conglomerates like Fosun are becoming increasing difficult to analyze post the spate of acquisitions, hence we have excluded it in our analysis below;

- 2H tends to be seasonally better than 1H. On a full year basis, 2014 aggregate revenues were 6% lower (Figure 20). This was primarily on account of lower ASPs, as volumes and utilisation rates were broadly stable. The pressure on ASPs was from excess supply in the industry in many cases. This combined with higher SGA expenses (more than offsetting the benefits from lower raw material costs in some instances) led to continued pressure on EBITDA margins. Aggregate EBITDA was down by 9%;

- Lower EBITDA with higher interest burden from debt raised in the past pressured interest coverage ratios (5.4x to 4x) and Operating cash flows, which declined 29%. We do acknowledge that management overall were prudent with cash flow management as working capital improved and contributed positively to OCF for most companies. Capex was cut 20% in total and dividends were also slashed, albeit these couldn't prevent FCF from being quite negative (though less so versus 2013);

- In the absence of meaningful equity raising, the negative FCF was funded by cash on hand and additional debt, leading to increase in net debt and deterioration in leverage metrics. Gross and net leverage were higher at 4.3x and 2.8x, up from 3.2x and 1.8x respectively. Liquidity however was largely stable with Cash to Short term debt ratio at 124%. Again, not surprisingly, we have already seen a few negative rating actions on the back of results announcements;

- Looking ahead, we believe this space is still over rated and expect negative rating actions to continue outweighing positive ones. Forward guidance from management across the board was lukewarm at best on the operational level. But capex spend should stay muted. Also, working capital can be squeezed only to an extent in our view, hence some of the positives here might not repeat. More importantly, companies with bonds maturing in 2016, like Texhong, Fufeng and China Automation expressed a preference to refinance in the local bank / syndicated loan market to save on interest, meaning supply in the sector could remain low.

Bond market reaction

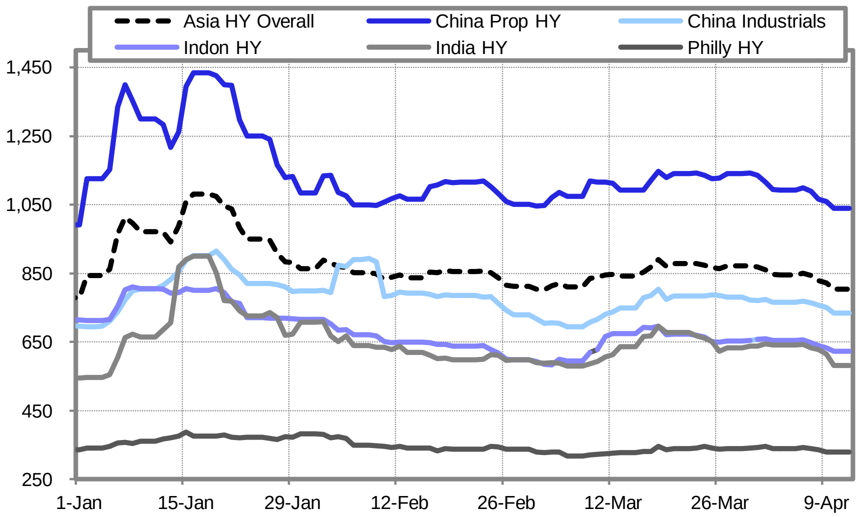
On average, China industrial bonds spreads are 17bp wider since beginning of March, underperforming the broader Asian HY market (Figure 21). Individual bond performance has been largely in line with their results (Figure 22). Worst performers were the ones with weakest results, i.e., the commodity credits. Infrastructure related corporates and department store operators have held up reasonably well despite soft numbers on account of better technicals and name-specific factors at play. Metals & mining and consumer sector bonds have fared relatively better.

Figure 48:Key Financials for China HY Industrials

Income statement	FY11	FY12	FY13	1H14	2H14	HoH	FY14	YoY
	RMBm	RMBm	RMBm	RMBm	RMBm		RMBm	
Total Revenues	146,211	156,883	162,195	74,839	77,591	3.7%	152,428	-6.0%
Gross Profit	47,403	49,974	48,551	21,555	21,969	1.9%	43,525	-10.4%
EBITDA	35,938	36,961	33,808	16,161	14,572	-9.8%	30,730	-9.1%
Interest Expense	(3,271)	(4,651)	(6,312)				(7,703)	22.0%
Cash Flow	**FY11**	**FY12**	**FY13**	**1H14**	**2H14**	**HoH**	**FY14**	**YoY**
Operating Cash Flow	13,387	18,456	9,971	3,076	3,986	29.6%	7,062	-29.2%
Capex & Acquisitions	(24,625)	(29,877)	(33,149)	NA	NA		(26,524)	-20.0%
Free Cash Flow	(11,239)	(11,422)	(23,178)	NA	NA		(19,462)	-16.0%
Balance Sheet	**FY11**	**FY12**	**FY13**	**1H14**	**2H14**	**HoH**	**FY14**	**YoY**
Cash	46,345	51,699	47,107	55,075	56,009	1.7%	47,563	1.0%
Short Term Debt	22,700	38,233	39,582	38,665	41,229	6.6%	38,298	-3.2%
Total Debt	59,889	83,834	107,117	122,685	140,323	14.4%	132,906	24.1%
Net Debt	13,544	32,136	60,011	67,611	84,313	24.7%	85,342	42.2%
Total Capitalization	163,517	204,285	239,331	265,030	298,329	12.6%	279,581	16.8%
Credit Ratios	**FY11**	**FY12**	**FY13**	**1H14**	**2H14**		**FY14**	
Gross Margin	32.4%	31.9%	29.9%	28.8%	28.3%		28.6%	
EBITDA Margin	24.6%	23.6%	20.8%	21.6%	18.8%		20.2%	
EBITDA/Interest Expense	11.0x	7.9x	5.4x	NA	NA		4.0x	
Total Debt/EBITDA	1.7x	2.3x	3.2x	3.8x	4.8x		4.3x	
Net Debt/EBITDA	0.4x	0.9x	1.8x	2.1x	2.9x		2.8x	
Total Debt/Total Capital	36.6%	41.0%	44.8%	46.3%	47.0%		47.5%	
OCF/Total Debt	22.4%	22.0%	9.3%	5.0%	5.7%		5.3%	
Cash/ST Debt	204.2%	135.2%	119.0%	142.4%	135.8%		124.2%	

Source: Deutsche Bank, company data
Note: Companies include Geely, Yingde, Hongqiao, MIE, Hengdeli, Parkson, Texhong, Shanshui, Anton, Maoye, Zoomlion, Car Inc., and China Automation

Figure 49:Historical Z-spreads by sector



Source: Deutsche Bank, Bloomberg Finance LP. Data as of 9-April-2015. Z-spreads are weighted average by current outstanding

Figure 50: Bond performances – China HY Industrials

Bond	Credit Rating Mdys/S&P/Fitch	Mid Price 2nd Mar	Mid Price 15th Apr	Price Change	Mid YTM (%) 15th Apr
ANTOIL 7.5% '18	B2/NR/B+	71.8	68.0	(3.8)	21.2
CHIOIL 5.25% '18	Ba1/BB+/NR	102.0	101.6	(0.4)	4.8
CHIOIL 5% '20	Ba1/BB+/NR	98.5	98.0	(0.5)	5.6
CHOGRP 8% '15	Caa1/NR/BB-	95.5	99.1	3.6	12.2
CHOGRP 7% '17	Caa1/NR/BB-	83.0	91.1	8.1	11.4
FOSUNI 7.5% '16	B1/BB/NR	102.6	102.8	0.1	5.3
FOSUNI 6.88% '20	B1/BB/NR	100.9	104.6	3.8	5.8
FUFENG 7.63% '16	NR/BB/BB-	101.8	102.3	0.5	5.6
CARINC 6.13% '20	Ba1/BB+/BB+	101.5	103.0	1.5	5.5
GEELY 5.25% '19	Ba2/BB+/NR	101.8	104.3	2.5	4.3
HONGQI 7.63% '17	NR/BB/BB	101.3	101.9	0.6	6.9
HONGQI 6.88% '18	NR/BB/BB	98.9	100.1	1.3	7.0
HONHUA 7.45% '19	B3/NR/BB-	59.5	57.0	(2.5)	23.6
MAOIH 7.75% '17	Ba3/BB-/NR	94.1	98.9	4.8	8.6
MIEHOL 6.88% '18	NR/B/B	75.0	73.0	(2.0)	20.5
MIEHOL 7.5% '19	NR/B/B	69.5	69.3	(0.3)	19.2
PRKSON 4.5% '18	Ba3/NR/BB-	91.8	92.9	1.1	7.3
SHASHU 7.5% '20	NR/B/BB	99.0	101.1	2.1	7.3
TEXTEX 7.63% '16	Ba3/BB-/NR	102.4	103.3	0.9	3.8
TEXTEX 6.5% '19	Ba3/BB-/NR	97.5	101.0	3.5	6.3
WESCHI 6.5% '19	B1/B+/BB-	98.0	100.9	2.9	6.4
XINHD 6.25% '18	Ba2/NR/BB	99.0	103.3	4.3	5.1
YINGDZ 8.13% '18	B1/BB-/BB	91.6	94.3	2.6	10.8
YINGDZ 7.25% '20	B1/BB-/BB	83.3	87.9	4.6	10.8
ZOOMLI 6.88% '17	NR/B+/BB+	101.5	102.3	0.8	5.9
ZOOMLI 6.13% '22	NR/B+/BB+	90.0	88.5	(1.5)	8.3
CNAUTO 7.75% '16	B1/BB-/NR	97.5	100.5	3.0	7.2

Source: Deutsche Bank, Bloomberg Finance LP
Note: Shashu's reoffer price as of 10th Mar used to calculate price change

Strategy

Given the continued weakening trend in fundamentals, we stick to our strategy of sticking to the biggest and the best here. While we don't foresee default rates picking up, we are wary of headline risks. We like some of the consumer stories, but these bonds are already trading tight and it's hard to find value. We also like select short dated bond with high yield with the view that they will be successfully refinanced.

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China property: Key takeaways of FY14 results

FY14 results of most Chinese property developers were generally weaker than market expectations, though we don't think it came in at a surprise as many of the companies missed their sales target last year. Overall credit trend of the industry continued to deteriorate, showing the weakest performance since the financial crisis in 2008. However, liquidity remains sound and most management are turning less aggressive on growth and shifting focus on clearing existing inventory and on managing capex spending.

Within our coverage, CIFI, Longfor and Yuexiu REIT were the clear outperformers in terms of credit trend. They showed improvements in five to six out of seven key credit ratios that we track. See Figure 27. Most property companies have witnessed a weakening credit trend, with COGO, Evergrande, Hopson, Poly Property, and Wanda being the worst performers showing deterioration in all the seven credit metrics.

Figure 51: Revenue, EBITDA and net profit growth of China property developers

Company	Stock code	Revenue growth (%)		EBITDA growth (%)		Net profit growth (%)	
		FY13	FY14	FY13	FY14	FY13	FY14
Agile	3383.HK	18.5	8.1	(4.1)	(6.5)	(3.5)	(11.2)
COLI	688.HK	27.7	45.5	9.4	38.0	23.1	20.1
COGO	81.HK	63.7	(12.1)	35.8	(43.5)	30.6	(59.6)
CR Land	1109.HK	60.9	23.8	24.3	35.1	39.1	0.1
China SCE	1966.HK	81.2	4.5	41.0	30.9	32.1	1.4
China Vanke	2202.HK	31.6	8.3	8.6	(4.1)	20.5	4.1
CIFI	884.HK	46.2	35.9	62.5	48.4	(2.2)	(1.7)
Country Garden	2007.HK	49.7	34.8	10.4	15.6	24.2	20.1
Evergrande	3333.HK	43.5	18.9	59.9	(4.6)	37.5	(0.1)
Franshion	817.HK	20.6	42.6	27.8	20.7	25.1	25.3
Future Land	1030.HK	18.6	(0.3)	18.1	(24.4)	5.4	4.5
Greentown	3900.HK	(18.1)	10.5	(25.1)	(5.8)	0.7	(57.6)
R&F	2777.HK	19.5	(4.3)	13.1	(20.1)	38.7	(31.6)
Hopson	754.HK	57.6	8.9	65.3	(12.8)	29.1	(23.5)
Kaisa	1638.HK	63.3	(3.2)	91.9	6.7	37.9	29.7
KWG	1813.HK	(2.2)	10.5	(8.6)	(0.9)	14.3	19.0
Longfor	960.HK	48.8	22.8	(0.9)	16.5	27.6	3.9
Poly Property	119.HK	38.3	(0.4)	(1.5)	(20.7)	3.3	(65.8)
Poly Real Estate	600048.CH	34.2	18.5	14.3	15.7	27.4	13.5
Road King	1098.HK	22.6	11.1	7.0	11.9	22.4	0.3
Shimao	813.HK	44.8	35.1	58.4	31.0	28.2	9.7
Sunac	1918.HK	48.0	(18.7)	33.5	(50.7)	21.9	1.4
Wanda Commercial	3699.HK	46.8	24.3	20.4	16.8	(10.0)	1.0
Yanlord	YLLG.SP	9.5	4.0	1.2	(18.0)	(19.2)	(7.8)
Yuexiu Property	123.HK	75.0	10.5	11.5	(3.0)	16.1	(14.2)
Yuexiu REIT	405.HK	92.5	14.6	62.1	5.2	(8.8)	60.8
Yuzhou	1628.HK	91.9	4.9	51.9	25.3	102.6	(14.7)
Average		**42.0**	**13.3**	**25.5**	**3.8**	**20.9**	**(2.7)**

Source: Company, Deutsche Bank

In summary, major industry and credit trends of Chinese property developers are:

- Developers' **revenue and EBITDA growth both fell in 2014**. On average, they declined from 42.0% and 25.5% in 2013 to 13.3% and 3.8% in 2014, respectively, and reached the lowest levels since 2008.
- One of the key noticeable trends of the industry is persistent **margin compression**, as a result higher unit land cost and labor cost, as well as price discounts offered for properties sold in a weak market in 2012 and for old inventory sold in 2014. In addition, many developers also saw an increase in revenue contribution from mass market products and from lower-tier cities, which often have lower ASP and with lower profit margins.
- As shown in Figures 26 and 27, many developers saw **deteriorating trends in credit metrics**. On average, EBITDA interest coverage ratio fell to 2.7x in 2014 from 3.2x in 2013, while debt-to-EBITDA ratio also rose to 6.7x from 5.4x. During the same period, net gearing ratio increased to 63.4% from 61.1%. If treating 50% of perps as debt and 50% as equity, the net gearing ratio surged to 74.1% from 69.0%. The main reason for the deterioration was a jump in debt amid slower property sales and operating cash flows, and weaker revenue and earning bookings.
- **Average borrowing cost was lowered moderately** to 8.0% in 2014 from 8.2% in 2013, on average. Some companies, such as China SCE, Future Land, Kaisa and Yuexie Property, successfully cut their borrowing cost by over 100bps. In contrast, a few developers, including Agile and R&F, saw an increase in average borrowing cost by almost 100bps owing to increased usage of more costly funding such as trust loans. Almost all developers have indicated their plans to raise more onshore bank loans or domestic corporate bonds or MTNs. But these plans were sounded out when offshore bond market was lukewarm and before property stimulus announced in late March. We won't be surprised to see more new issuances from Chinese developers should the offshore bond market reopen.
- **A few** developers have cut dividend significantly, including China SCE, Greentown, Hopson and R&F, **declaring zero dividend** for 2014 to preserve cash. On the other hand, some companies including Evergrande, Road King and Yuexiu REIT continued to maintain a high dividend payout of about 50%/40%/over 100%, respectively.
- **Most developers achieved negative cash flow before financing in 2014**, indicating continuous reliance on debt funded expansion.
- Positively, **liquidity remained robust** for most developers with total cash covering short-term debt by 1.9x on average at YE14, although weakening from 2.3x at YE13.
- **More developers are using perpetual securities**, up from six companies to eleven companies. Evergrande is the most active user of onshore perps, with total outstanding amount of RMB53bn at YE14 and exceeding its common equity of RMB51bn. Increased usage of perps could soon exert financial pressure on the company, if they don't repay before a steps-up period kicks in two to three years with interest rates adjusting to as high as 13-18%.
- **Some companies have aggressively increased usage of trust loans for liquidity needs.** For example, Agile, Evergrande, R&F raised additional trust loans of RMB2bn/RMB34bn/RMB5bn in 2014, respectively, equivalent to a growth of 33%/104%/31%.

- **There is a growing trend of setting up JVs among developers**. In some cases, such as KWG and Sunac, their shares of results from JCEs were quite significant, contributing 47% and 68% respectively of their net profit in 2014. This may distort the true underlying performance of the company (as the share of results from JCEs may include revaluation gains and other non-cash items, which we do not view as quality earnings) and raise subordination risk for offshore bondholders, in our view.
- **Forward guidance from management has turned less aggressive**, with a median target sales growth of 13% for 2015.
- **Many developers have sounded out plans to focus on clearing inventory and cut capex spending** on land acquisitions or new construction start. This could be a positive credit development to strengthen their balance sheet. A few companies have indicated accelerated land acquisition plans including CIFI, COLI, China SCE and Yuzhou. They plans to spend 33%-47% of contracted sales on land purchases in 2015, compared with the median target spending of 24%.

Figure 52: Credit performance of Chinese property developers in 2013 and 2014

Company	Stock code	EBITDA margin (%)		EBITDA interest coverage (x)		Debt / EBITDA (x)		Total debt / Capital (%)		Net debt / Equity* (%)		Net debt / Equity^ (%)		Average borrowing cost (%)	
		FY13	FY14	FY13	FY14	FY13	FY14	FY13	FY14	FY13	FY14	FY13	FY14	FY13	FY14
Agile	3383.HK	28.1	24.3	3.7	2.6	4.0	4.5	52.2	50.7	73.4	75.2	84.7	85.3	7.9	8.9
COLI	688.HK	31.5	29.8	10.9	9.8	2.8	2.6	39.6	40.9	28.1	31.6	28.1	31.6	3.6	4.4
COGO	81.HK	28.9	18.6	6.9	2.6	3.2	7.9	54.5	61.3	44.1	70.4	44.1	70.4	6.1	5.6
CR Land	1109.HK	23.2	25.3	7.2	6.5	3.9	3.8	41.0	44.6	39.2	42.7	39.2	42.7	3.9	4.5
China SCE	1966.HK	21.7	27.2	1.6	1.8	6.8	6.5	53.3	52.6	62.7	68.0	62.7	77.5	10.6	9.5
China Vanke	2202.HK	21.7	19.3	4.2	3.9	2.8	2.6	42.5	37.3	31.7	5.4	31.7	5.4	8.7	9.3
CIFI	884.HK	19.0	20.7	2.1	2.3	5.9	4.1	59.4	54.5	67.6	58.2	67.6	62.3	9.8	10.5
Country Garden	2007.HK	21.1	18.1	3.2	3.1	4.2	4.0	55.0	49.4	64.3	54.2	64.3	58.1	8.8	8.3
Evergrande	3333.HK	20.5	16.5	2.4	1.3	5.7	8.5	57.8	58.1	69.5	85.9	101.3	143.1	9.6	10.3
Franshion	817.HK	37.1	31.4	3.8	3.6	4.7	5.0	43.1	45.4	44.5	58.1	51.9	64.8	6.2	6.2
Future Land	1030.HK	16.5	12.5	2.8	2.0	4.1	5.4	56.7	53.0	52.8	52.6	52.8	52.6	10.3	9.3
Greentown	3900.HK	25.1	21.4	3.0	2.2	4.9	5.2	52.7	50.7	76.3	76.7	82.3	84.7	8.1	8.7
R&F	2777.HK	33.4	27.9	3.1	1.7	5.1	7.0	64.7	56.5	110.8	91.7	114.0	125.6	8.0	9.0
Hopson	754.HK	27.0	21.6	1.3	1.0	9.3	13.4	41.7	46.0	59.5	73.6	59.5	73.6	8.1	8.3
Kaisa	1638.HK	24.9	28.7	1.9	2.4	4.6	6.0	50.5	53.6	62.1	73.3	62.1	76.7	13.6	8.5
KWG	1813.HK	26.3	23.6	1.3	1.1	8.4	9.9	54.0	54.5	56.3	66.8	56.3	66.8	10.2	10.1
Longfor	960.HK	23.2	22.0	3.7	4.0	3.9	4.3	48.8	48.7	58.4	57.1	58.4	57.1	7.4	6.5
Poly Property	119.HK	15.3	12.2	1.2	0.8	10.1	15.2	57.6	60.7	88.1	102.1	88.1	105.1	8.3	8.4
Poly Real Estate	600048.CH	23.6	23.1	3.2	3.0	4.8	5.3	58.9	60.9	94.5	106.5	94.5	106.5	7.3	7.1
Road King	1098.HK	22.6	22.7	2.4	2.4	5.5	5.2	51.3	51.8	54.4	78.6	54.4	78.6	8.3	8.2
Shimao	813.HK	26.2	25.4	3.0	3.3	4.5	4.4	48.8	48.8	57.5	58.6	57.5	58.6	8.0	7.8
Sunac	1918.HK	19.7	11.9	2.4	1.0	4.7	11.5	61.2	62.1	69.7	44.5	69.7	44.5	10.2	9.6
Wanda Commercial	3699.HK	33.4	31.3	3.0	2.7	4.5	5.4	53.4	53.8	49.8	56.7	49.8	56.7	8.8	8.0
Yanlord	YLLG.SP	28.9	22.8	2.7	1.8	5.4	7.4	38.6	40.4	37.4	45.2	37.4	45.2	7.7	8.0
Yuexiu Property	123.HK	21.5	18.9	2.0	1.8	7.8	10.8	48.7	51.4	61.6	63.1	61.6	63.1	6.9	5.9
Yuexiu REIT	405.HK	50.4	50.7	2.1	2.6	9.2	9.0	38.1	38.0	56.5	53.7	210.9	205.5	5.0	4.4
Yuzhou	1628.HK	26.1	31.2	2.2	2.1	5.0	6.3	56.5	62.1	78.0	59.8	78.0	59.8	10.1	9.2
Average		**25.8**	**23.7**	**3.2**	**2.7**	**5.4**	**6.7**	**51.1**	**51.4**	**61.1**	**63.4**	**69.0**	**74.1**	**8.2**	**8.0**

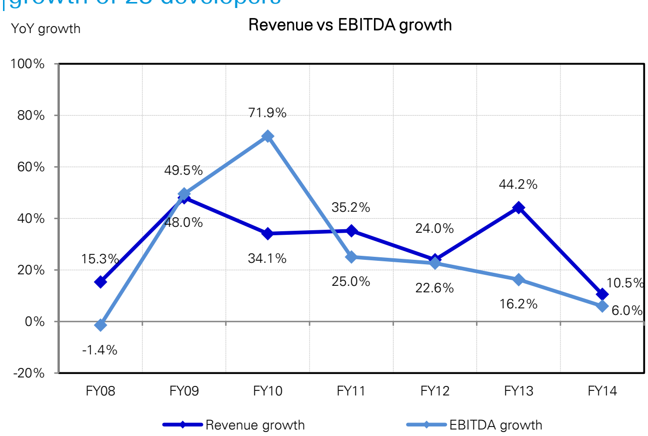
Source: Company, Deutsche Bank
*Note: * Net debt is total debt minus total cash, including restricted and unrestricted cash; ^ Treating 50% of hybrid as debt and 50% as equity*

Figure 53: Summary of credit trends of individual Chinese property developers

	EBITDA growth	EBITDA margin	EBITDA interest coverage	Debt / EBITDA	Total debt / Capital	Net debt / Equity^	Total cash / Short-term debt	Number of ratios showing improvement
Agile					improved			1
COLI	improved			improved				2
COGO								0
CR Land	improved	improved		improved			improved	4
China SCE		improved	improved	improved	improved			4
China Vanke				improved	improved	improved	improved	4
CIFI		improved	improved	improved	improved	improved		5
Country Garden	improved			improved	improved	improved		4
Evergrande								0
Franshion							improved	1
Future Land					improved	improved		2
Greentown	improved				improved			2
R&F					improved			1
Hopson								0
Kaisa		improved	improved					2
KWG	improved							1
Longfor	improved		improved		improved	improved	improved	5
Poly Property								0
Poly Real Estate	improved							1
Road King	improved	improved		improved				3
Shimao			improved	improved				2
Sunac						improved		1
Wanda Commercial								0
Yanlord							improved	1
Yuexiu Property							improved	1
Yuexiu REIT		improved	improved	improved	improved	improved	improved	6
Yuzhou		improved				improved	improved	3
Number of companies showing improvement	8	7	6	9	10	8	8	

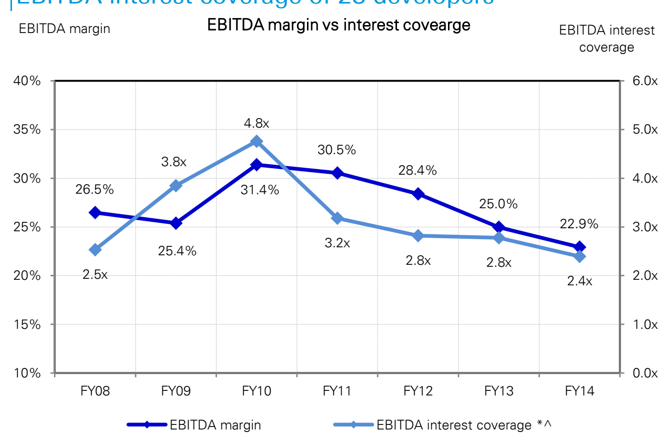
Source: Deutsche Bank
*Note: * Net debt is total debt minus total cash, including restricted and unrestricted cash*

Figure 54: Median average of revenue and EBITDA growth of 28 developers



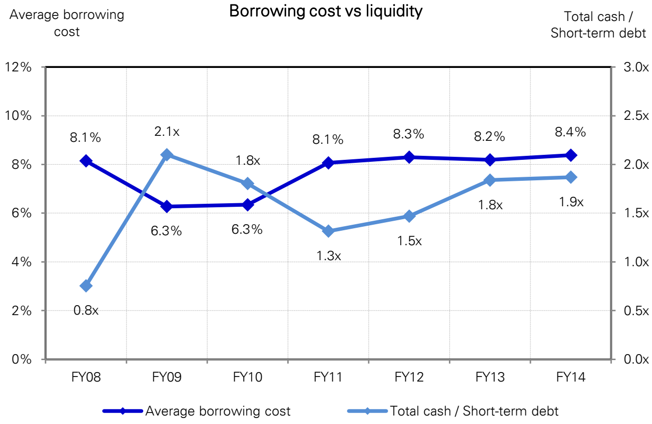
Source: Company, Deutsche Bank

Figure 55: Median average of EBITDA margin and EBITDA interest coverage of 28 developers



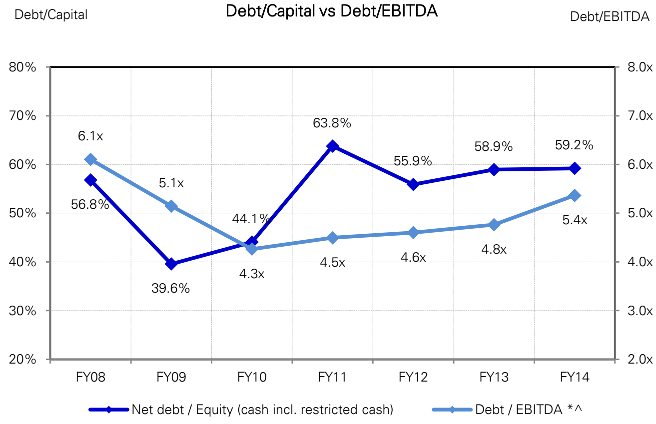
Source: Company, Deutsche Bank

Figure 56: Median average of borrowing cost and cash-to-short-term-debt of 28 developers



Source: Company, Deutsche Bank

Figure 57: Median average of debt-to-capital and debt-to-EBITDA ratios of 28 developers



Source: Company, Deutsche Bank

Bond market reaction

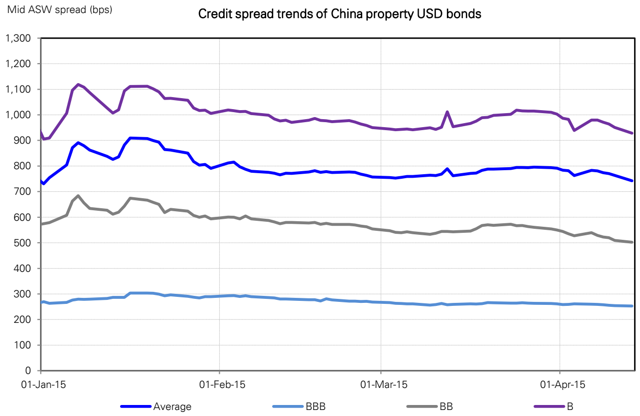
China property bonds have rallied since end of March following announcements of stronger-than-expected policy stimulus, outperforming the broader Asian HY market. IG was up 1.3 points on average, while HY was up 1.8 points since end of February. BB bonds led the rally, gapping 52bps on average in terms of ASW spread, while B followed (-22bps) and IG lagged (-15bps). Individual bond performance has lost link with their results. Best performed bonds were the ones with the weakest results, e.g. Hopson and Greentown (jumped 8.8 to 12.4 points). See Figure 32 below. In contrast, the worst performers were the one with the best results e.g. CIFI and Yuexiu REIT (bonds were down 0.5 points or up only 1 point, respectively). High-beta, low-rated bonds have outperformed. Technicals clearly have overwhelmed fundamentals.

Figure 58: Top 10 out/underperformed bonds since end of February

Bond	YTW (%)	Price on 27 Feb	Price on 14 Apr	Price change	Change in Z-spread (bps)
Top 10 outperformers					
HPDLF'18C16	9.39	88.75	101.13	12.38	-529
KAISAG'18C16	23.15	59.50	71.50	12.00	-996
KAISAG'19C17	19.29	59.75	71.50	11.75	-539
KAISAG'20C17	19.78	60.00	71.50	11.50	-497
FTHDGR'20C17	14.70	77.00	86.75	9.75	-318
GRNCH'PerpC19	8.29	93.50	102.25	8.75	-4
FTHDGR'19C17	14.31	81.00	89.50	8.50	-311
MOLAND'18C16	14.42	91.00	98.50	7.50	-271
FTHDGR'17	13.37	93.50	100.75	7.25	-346
COGARD'23C18	6.93	96.13	102.63	6.50	-136
Top 10 underperformers					
YUZHOU'18C16	9.13	98.50	98.88	0.38	3
CHIOLI'17	2.20	104.45	104.77	0.32	-21
TPHL'17 CNH	13.53	93.75	94.00	0.25	-25
EVERRE'20C18	11.95	100.00	100.13	0.13	10
CRHZCH'16	1.92	102.97	102.90	-0.07	-13
CIFIHG'18C16	8.28	109.75	109.38	-0.38	-17
CIFIHG'19C17	8.55	101.50	101.00	-0.50	28
GLOPRO'18C16	34.43	64.00	63.00	-1.00	152
GLOPRO'15C14	47.77	87.00	85.38	-1.63	1,051
COFCO'23	7.05	87.07	85.21	-1.86	48

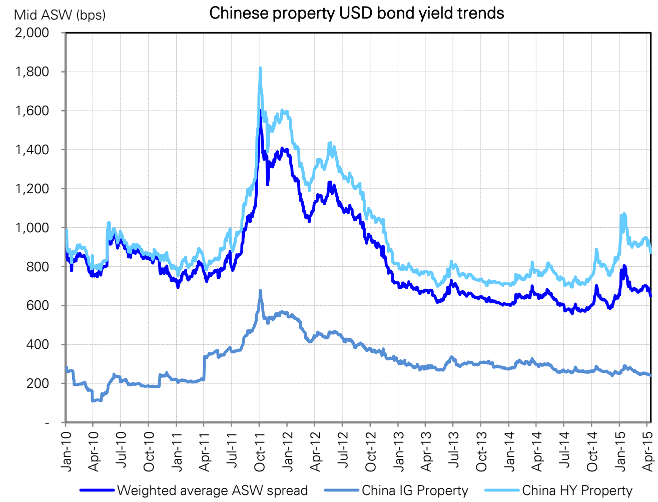
Source: Bloomberg Finance LP, Deutsche Bank

Figure 59: Credit spread trends of China property B, BB and BBB since early January 2015



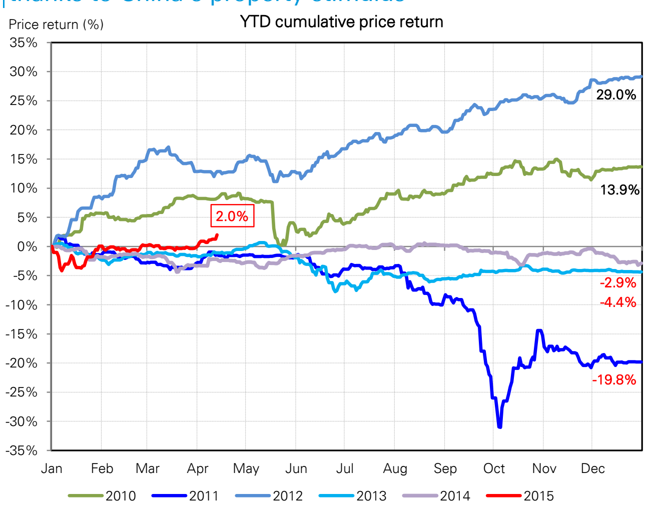
Source: Deutsche Bank, data as of 13 April 2015

Figure 60: Historical bond performance of China property IG vs HY



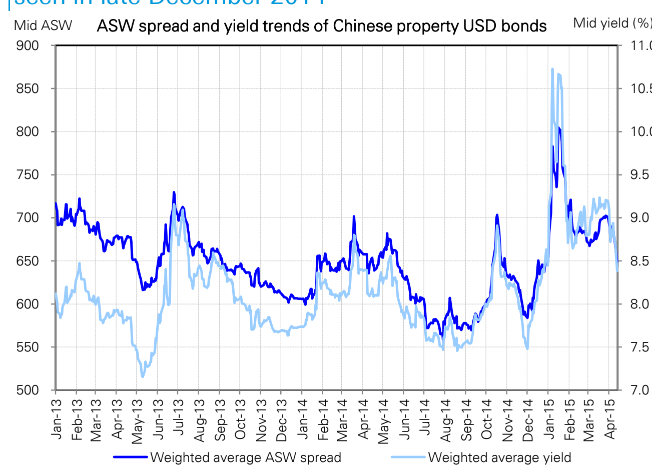
Source: Deutsche Bank, data as of 13 April 2015

Figure 61: China property has rallied since late March, thanks to China's property stimulus



Source: Deutsche Bank, data as of 13 April 2015

Figure 62: China property bonds have tightened to levels seen in late December 2014



Source: Deutsche Bank, data as of 13 April 2015

Strategy

We are turning more neutral on the sector in view of the encouraging property stimulus. We believe the recent new measures of lowering downpayment requirements will be effective in stimulating property demand. Moreover, our China economists expect further significant policy easing in Q2, with RRR cut in April and interest rate cut in May. These should be supportive for investors' sentiment on the sector. With the recent surge in stock prices, some developers have started raising equity to strengthen their balance sheet. For instance, Country Garden has recently announced its plan to raise HKD6.3bn from a private share placement to Ping An Life. We won't be surprised to see more share placements. That said, the industry continues to face challenges from hiking competition, margin compression pressure, high property inventory, and persistent financial stress from highly geared balance sheets with credit profiles that are the weakest since the financial crisis in 2008. With overall sales down 12% yoy in the first quarter, developers still have lots to catch up in order to meet their sales target for 2015.

Looking ahead, credit metrics of Chinese property developers could improve if they really stick to their plans to cut capex and strengthen their balance sheets. Although we think there could be further legs in the rally, what's holding us from turning outright positive on China property bonds is valuation. With the weighted average sector yield now gapping to 8.3%, the lowest in the year, these bonds are trading tight, in our view, and it is getting more difficult to find value. Further gapping in yield could also fuel more new issuances from Chinese developers. From a relative value perspective, we think some IG bonds are trading too tight relative to some selective B bonds. We do like short-dated, lower-rate bonds with a view that they will be successfully refinanced. We also continue to prefer property issuers with a focus on the mass market products and on housing upgrade which should benefit from favorable policies.

China property recommendations

Top picks: CHIOLI’43, FUTLAN, GRNCH’16, ’18 &’19

Top pans: AGILE'19C17, GZRFPR’19C17, GZRFPR’20C17, KWGPRO’19C17 Old and New, KWGPRO’20C17, YXREIT’18

Recommendation changes: Upgrade CHIOLI'43 to Buy from Hold, Downgrade CHIOLI'20&22 to Hold from Buy

Please refer to Figures 46-47 for the comprehensive list of trade recommendations, rationale and risks.

Jacphanie Cheung, Hong Kong, +852 2203 5930

Offshore RMB Market Monitor

- Analyzing the CNH CCS market: The CNH cross currency swap (CCS) market has developed over time and has now evolved into one of the most actively traded offshore RMB derivative curves. In this report, we present our analysis of this market to help you understand the balances of flows, factors that drive such flows, and how to capture investment opportunities to serve your business and investment needs in the RMB market. We start by looking at fundamental variables in CNH CCS pricing, then we identify and analyze the five primary types of flows in the CNH CCS market. We discuss the recent flow dynamics and explain our rationale for retaining a bullish view on CNH CCS rates. We recommend receiving 1Y CNH CCS at 3.6% with a revised target of 2.6%, down from 2.9% following the interest rate cut on 11 May.
- Offshore RMB policy update: On the policy front, the main theme since the start of this year has been China continuing to refine the offshore RMB clearing infrastructure and steadily expand the RMB QFII scheme globally.
- Recent developments in Taiwan's Formosa bond market. RMB bond issuance in Taiwan's Formosa bond market surged this year thanks to the relaxation of insurers' investment restrictions. We see three key market implications: (a) RMB Formosa bonds account for a rising share of the offshore RMB bond market; (b) RMB Formosa bonds have extended the duration of the offshore RMB bond yield term structure from the 3Y tenor to the 30Y tenor; (c) it improves trading activity at the long end of the CNH CCS curve. While we expect demand from Taiwan insurers to remain supportive for the RMB Formosa bond market, the recent rally in the CNH CCS curve has narrowed the potential cost savings for RMB swap-based borrowers. This suggests that RMB Formosa bond issuance is more likely to be driven by RMB financing (borrowers with real RMB cash demand) in the next few months.
- Q2 supply outlook. We forecast Q2 net supply of offshore RMB bonds and CDs at RMB90bn. We expect both IG corporate names and sovereign/quasi sovereign names to outperform the high yield sector.
- Offshore RMB deposit base update: We maintain our forecast that the offshore RMB deposit pool will grow 30% YoY to RMB3.25trn by the end of 2015, boosted by RMB investment and diversification demand from corporates, institutions, and foreign central banks.
- Q1 RMB settlement rose to 27% of China's global trade, above our forecast of 25% for the full year 2015. We expect RMB investment settlement to grow strongly going forward as China opens up its domestic capital market and relaxes capital account control. We expect the RMB investment settlement share to grow towards 20% of total RMB settlement volume by the end of 2015.
- Stable offshore RMB market turnover in Q1 suggests that the growth in RMB cross trade and investment settlement volume has been offset by a reduction in offshore RMB capital market investment activities

Analyzing the CNH CCS market

Soon after the launch of the offshore RMB market in Hong Kong in H2 2010, the CNH cross currency swap (CCS) market began to develop and it has now evolved into one of the most actively traded offshore RMB derivative curves. The CNH CCS curve market has many interesting and unique characteristics. In this report, we present our analysis of this market to help you understand the balances of flows, factors that drive such flows, and how to capture investment opportunities to serve your business and investment needs in the RMB market.

Back to basics

The CNH CCS curve trades on the convention of fixed to floating rate, where the fixed leg is the CNH CCS rate, and the floating leg is the 3M USD Libor.. Because the fixed leg is deliverable in offshore RMB, the CNH CCS curve is effectively the offshore RMB interest rates on a cross currency basis, i.e. financing on the basis of exchanging principal and interest payments between the offshore RMB and the USD. Therefore, the CNH CCS rates reflect three fundamental variables:

(a) Offshore RMB liquidity conditions;

(b) Expectations for the forward path of USDCNH exchange rates;

(c) Expectations for RMB and USD long-term interest rate differentials.

Considering these fundamental aspects, the CNH CCS curve should respond to the following pricing indicators:

(a). Offshore money market rates: The CNH CCS reflects borrowing and lending conditions in the offshore RMB market, based on offshore RMB demand and supply.. Offshore RMB supply is determined by the offshore RMB liquidity pool and RMB cross border flow balances (for example, RMB QFII investment drains liquidity from the offshore to the onshore market, while Southbound trading under the Stock Connect injects liquidity into the offshore market). As the CNH CCS curve is a RMB funding curve collateralized by the USD, it naturally should correlate with cash funding rates, i.e. offshore RMB money market rates.

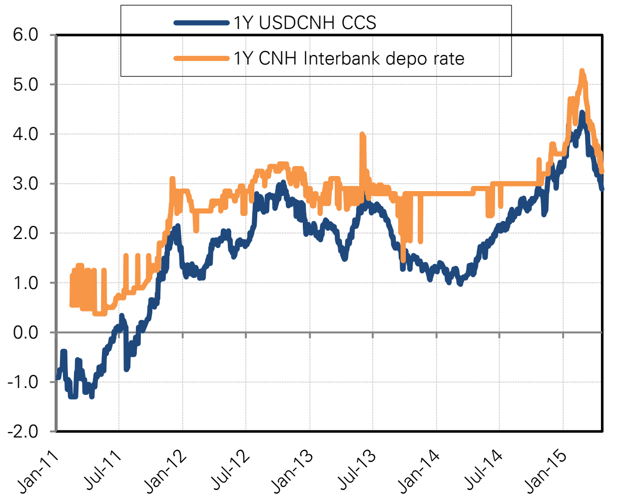
(b) Onshore CNY interest rates. Ultimately it is China's monetary policy and exchange rate policy that drive both the onshore and offshore RMB rates, so the CNH CCS curve should correlate with onshore RMB interest rates and investment/financing conditions. However, onshore and offshore interest rate pricing does not necessarily converge, due to (a) different regulatory environments and regulator costs (for example, onshore banks need to comply with RRR requirements while offshore does not have such requirement); and (b) limited free capital account flows and the lack of efficient arbitrage between the two markets. The degree of onshore and offshore RMB market convergence is determined by the pace at which China liberalizes its capital account. Since the second half of 2013, China has clearly accelerated the pace of capital account liberalization; as a result, the onshore offshore basis risk has become much less volatile and correlations between the onshore and offshore RMB interest rates have strengthened.

Figure 63: Market convention of the CNH CCS curve

Floating leg	USD 3M Libor
Fixed leg	CNH CCS rate
Payment Frequency	Quarterly
Tenor	1Y up to 10Y, 5Y+ tenors are less liquid
Avg trading size	USD 10-20m
Avg daily trading volume	USD1.5-2bn/week
Bid offer spread	3-5bps (1Y-3Y) and 4-8bps (4Y-5Y), 5Y+ is wider

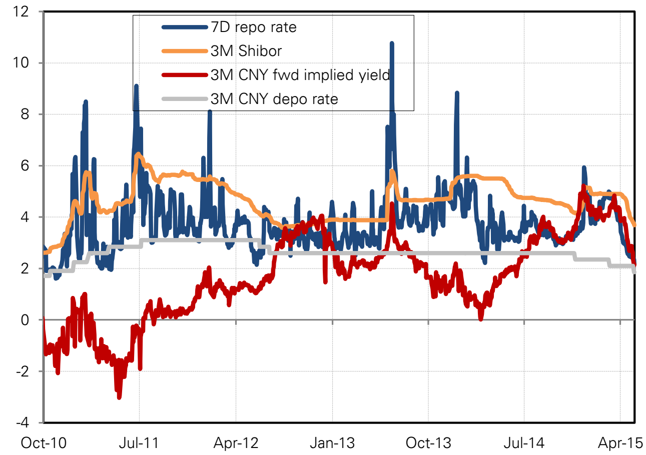
Source: Deutsche Bank

Figure 64: CNH CCS and offshore money market rates



Source: Deutsche Bank, Bloomberg Finance LP

Figure 65: CNH CCS and onshore CNY interest rates



Source: Deutsche Bank, Bloomberg Finance LP

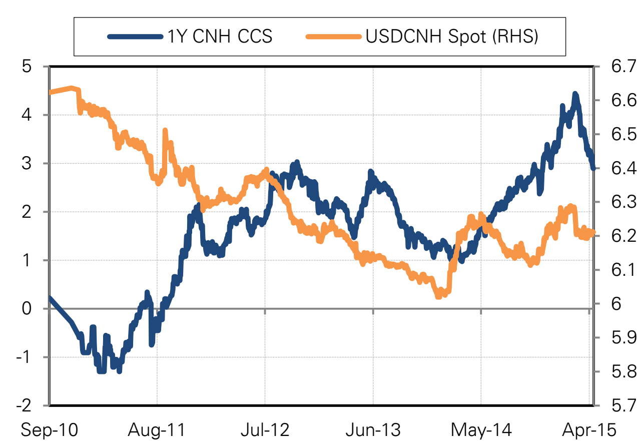
(c) USD interest rates: Because the floating leg of the CNH CCS transaction is the 3M USD Libor, the CNH CCS curve prices in expectations for the future path of USD short-term rates. If the market expects USD Libor to go up in the future, the CNH CCS curve should rise accordingly (when RMB valuation expectations are stable), and vice versa.

(d) RMB valuation: The CNH CCS curve has been highly sensitive to the RMB exchange rate. When RMB appreciated strongly, the CNH CCS traded below zero during September 2010 – August 2011 and stayed well below onshore CNY rates, even when onshore monetary policy was tightening, creating attractive financing opportunities for mainland corporate borrowers (borrowing in the offshore market to be used onshore). When RMB depreciated during 2014 and early this year, the CNH CCS rates sold off and even traded above the onshore RMB interest rates.

Figure 66: CNH CCS vs. USD IRS

Source: Deutsche Bank, Bloomberg Finance LP

Figure 67: CNH spot weakness was the main reason for the CCS selloff in Q1 (%)



Source: Deutsche Bank, Bloomberg Finance LP

The degree of pricing sensitivities of the CNH CCS varies from each of the above four pricing indicators, and in general, the front end of the CCS curve is highly sensitive to funding conditions and RMB exchange rate, while the long end of the CNH CCS curve is highly sensitive to RMB and USD interest rate differentials.

Primary flows in the CNH CCS market

The CNH CCS is the only deliverable offshore RMB interest rate derivative curve. As a result, with the increasing adoption of RMB as a settlement, investment and reserve currency, we have seen growing participation in this market by global corporations, global financial institutions, institutional investors, supranationals, foreign monetary authorities and foreign governments to meet their real financing and hedging needs. Hedge fund investors have traded more actively in this market in recent years as CCS market liquidity is improving.

Market players trade the CNH CCS curve for a range of purposes and we have identified five primary types of flows to help you understand the dynamics in the market. They are:

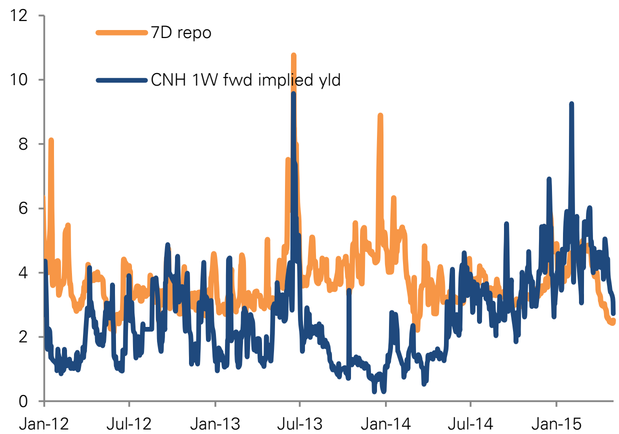
1. FX hedging flows by corporations. Pricing in the short end of the CNH CCS curve depends on the momentum in the CNH spot and forward market. As China's current account is fully open and with the great relaxation of RMB cross-border trade settlement schemes, exporters and importers usually have access to both onshore and offshore RMB markets to manage FX exposure from their global trades. Multinational corporations who operate in China use the CNH forward market to hedge their account receivables from China or equity investments in their underlying business.

2. FX hedging flows by institutional investors. As China opens up its domestic capital market, more foreigner investors now have access to bond and equity markets via QFII, RMBQFII, direct interbank bond market access and the Stock Connect programs. According to the PBoC, by the end of Q1 2015 overseas investors held RMB601bn of domestic equities and RMB718bn of domestic bonds. There were also about RMB877bn domestic loans and RMB2025bn of domestic deposits held by overseas investors. Moreover, institutional investors invest in the offshore RMB fixed income market, which has about a RMB710bn notional amount outstanding. Foreign asset managers who have foreign currency as their base/funding currency naturally seek to hedge their FX risk. Because QFII investors are not allowed to hedge FX risk on the onshore interbank FX market, they need to access the offshore market (either the CNH CCS or NDF market) to hedge.

3. Short-term financing flows by global banks. As CNH money market funding is less active (due to credit line issues, etc), to facilitate market making and corporate business, global banks usually borrow offshore RMB via FX swaps as many have relatively easy access to USD financing in the global market. Such financing tends to be very short so as to minimize interest rate duration exposure; hence the funding rate depends on the offshore RMB money market liquidity. During an offshore liquidity squeeze (for example, before the launch of the Hong Kong-Shanghai Stock Connect program last year), funding demand causes the short end of the FX implied yield to shoot up. For example, most recently in early February this year, the CNH 1W forward implied yield broke 9%.

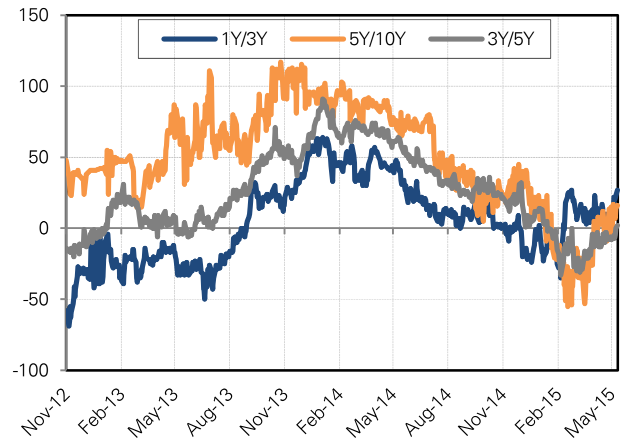
While these three types of flows affect mostly the front end (up to 2Y) of the CNH CCS curve, each flow has spillover effects on other flows. Major changes in the pricing of the front end of the curve have spillover effects on the medium to long tenors on the curve via transmission in the cash bond market and onshore FX and bonds market. We will discuss this point in our case study in the last section of this report.

Figure 68: Onshore and CNH money market rates



Source: Deutsche Bank, Bloomberg Finance LP

Figure 69: CNH CCS curve slope (bps)



Source: Deutsche Bank, Bloomberg Finance LP

4. Liability hedging on the back of offshore RMB bond issuance. There are two types of financing in the offshore RMB market. One is RMB financing, referring to those who have real RMB cash demand and take advantage of the relatively cheap financing cost in the offshore RMB market compared to the onshore RMB market, then use the RMB raised via offshore RMB bond placement or bank loans to make investments in China. Chinese domestic corporations and global corporations participating in the RMB FDI scheme fall into this category and they do not need to hedge liabilities via the CNH CCS curve. The other type is what we call "third party financing" or "RMB swap-based financing", which refers to RMB financing via bond issuance or bank loans for the purpose of swapping into USD or other currencies in order to achieve financing cost savings. Because borrowers for RMB swap-based financing hedge their liabilities by receiving CNH CCS rates, mostly in the 3Y and longer tenors, such flows tend to exert downward pressure on the 3Y and longer tenors, causing the 1Y/3Y part of the CNH CCS curve to invert.

How active the RMB financing or RMB swap-based financing depends on CNH CCS pricing. When CCS rates are relatively low compared to the onshore RMB rates, RMB financing flows tend to dominate; when CCS rates are relatively high, there is more demand for RMB swap-based financing. For example, if a corporate issuer who borrows by issuing 3Y USD bonds at 3M USD Libor + 80bps can issue RMB bonds at 4.5% and swap into USD by receiving 3Y CNH CCS at 3.9%, its implied USD funding cost is 3M USD Libor + 60bps, allowing it to capture 20bps savings vs. the cost via USD bond issuance.

5. Asset swap hedges by banks and investment institutions There are two main types of asset swap hedgers: commercial banks and investment institutions. Commercial banks in the offshore RMB market which extend long-term RMB credits/loans to borrowers hedge their long dated RMB risk at the long end of the CNH CCS curve. For example, if a Hong Kong-based commercial bank makes a 5Y RMB500mn loan to a Chinese corporation, because the bank relies on HKD or USD funding it would swap this RMB loan (bank's asset) into a USD Libor loan plus a spread by paying 5Y CNH CCS rates. By hedging out both the RMB interest rate risk and RMB exchange rate risk, the bank can reduce the currency mismatch of its asset and liability. Similarly, a fixed income asset management fund could buy offshore RMB bonds on an asset swap basis to capture the spread pickup against its funding currency. In a hypothetical case, buying a 3Y CNH paper (4.25%) issued by a Chinese bank and paying 3Y CNH CCS rates at 3.25% to lock in a spread of 100bps above USD 3M Libor would be more attractive than buying USD bonds by the same issuer that trade at a spread of 80bps over USD Libor.

In addition, hedge funds, corporates and market makers trade the CNH forward and CCS market for two other purposes: (a) speculative positioning to express long/short or bullish/bearish trading views; (b) relative value trading between onshore and offshore spot and forward markets (CNH, CNY and NDF curves), and between CNH CCS vs. NDIRS curves. These flows expose the CCS market to various correlation and curve dynamics.

All of these flows and the factors driving such flows in the CNH CCS market determine the duration, curvature and volatility risk of the CNH CCS curve. We analyze the case of recent flows in the CNH CCS market and explain the rationale of our bullish view on the CNH CCS curve.

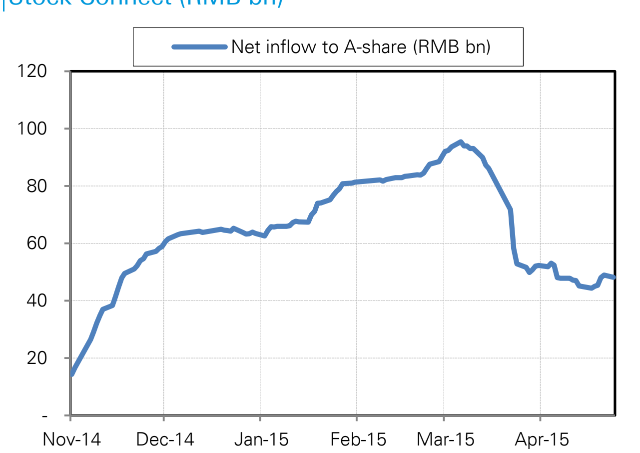
Retaining bullish view on CNH CCS rates

Since Q2 last year, the offshore RMB market liquidity has demonstrated a persistent tightening trend -- 1Y CNH CCS climbed from 1.2% to 4.3% in February. From a flow perspective, such behavior of CNH CCS rates can be explained by the following:

(a) Stock Connect related financing: The Stock Connect program was announced in May 2014. In order to facilitate RMB cross border investment flows under Northbound trading, global banks in the offshore RMB market have pre-funded large amounts of the RMB liquidity pool using FX swaps; this is the type 3 flows discussed above. On an aggregate basis, net investment inflow into the A-share equity market (this measures the net flow in RMB from offshore to onshore under the Stock Connect program) was about RMB64bn by the end of last year and peaked in late March at RMB95bn, before recently falling to about RMB49bn due to strong demand under Southbound trading (RMB supply to the offshore RMB market).

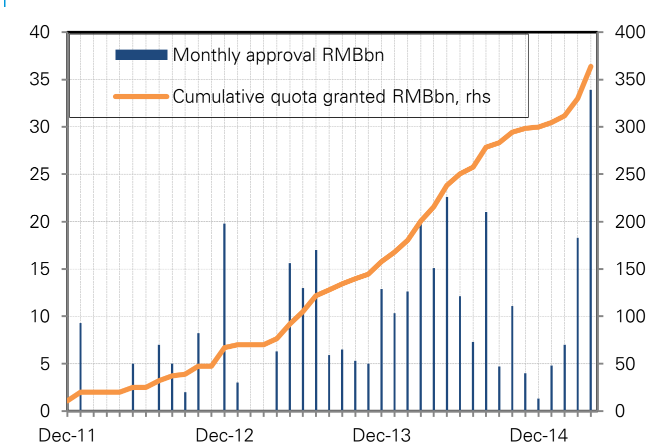
(b) Opening up of domestic fixed income market: By the end of April, about RMB363.7bn RMB QFII quota had been granted to 121 foreign institutional investors, in addition to the onshore direct interbank bond market access quota of approximately RMB1200bn, of which about 50% is granted to foreign central banks and sovereign wealth funds. Moreover, of the USD73.6bn QFII quota granted to foreign institutions, some of the funds have been invested in the onshore fixed income market. By the end of March, foreign investors held about RMB713bn of domestic bonds and RMB601bn of domestic equities.

Figure 70: Net inflow (to A share) of RMB under the Stock Connect (RMB bn)



Source: Deutsche Bank, Bloomberg Finance LP

Figure 71: RQFII quota approvals (RMB bn)



Source: Deutsche Bank, Bloomberg Finance LP

Offshore RMB liquidity continued to tighten in February this year, despite the fact that onshore CNY funding rates have been declining as China has gradually relaxed monetary conditions through liquidity injections and interest rates cuts since June 2014.

We believe the insufficient monetary policy transmission from the onshore money market to the offshore money market is because of:

(a) Limited channels of RMB supply from onshore to the offshore interbank market due to the asymmetric nature of the offshore RMB circulation mechanism, which favors RMB inflows to the onshore market; currently the market based channels for RMB supply are limited to RMB current account flows and the Southbound trading under the Stock Connect;

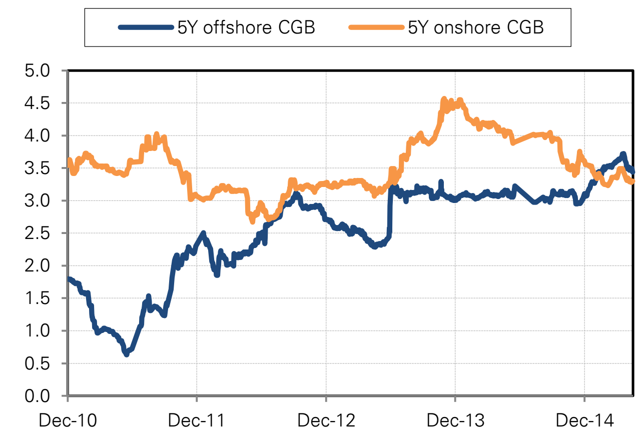
(b) The offshore RMB money market has not been efficient in accommodating liquidity demand in the market. RMB funding in the offshore interbank money market has been low due to credit line limits between among banks;

(c) Low usage of the offshore RMB intra-day liquidity facility provided by the HKMA. While the HKMA provides intraday liquidity facility, banks only tap into the facility to manage extreme liquidity stress, not for regularly day to day liquidity management.

As a result, most banks rely on the FX swap market for daily funding, and given the offshore RMB liquidity pool is relatively limited (RMB2trn deposits offshore vs. RMB122trn monetary base onshore) , it is inevitable that short term funding cost in the offshore market has been volatile and has been driven by CNH forward market pricing. Whenever China eases monetary condition, the immediate policy transmission is predominantly through the weakening CNH exchange rate which pushes up offshore RMB FX implied funding cost. Higher funding cost forced leveraged offshore RMB bond investment to be unwound, and bond market selloff led offshore interest rates to first converge with onshore rates then drift above onshore rates. For example, the basis between the 5Y offshore CGB yield and the 5Y onshore CGB yield was -120bps in February 2014; it then narrowed to zero in late January this year and is currently +14bps (offshore CGBs for the first time trade cheaper than onshore CGBs!). RMB interest rate derivatives -- the NDIRS and CNH CCS -- show a similar convergence trend.

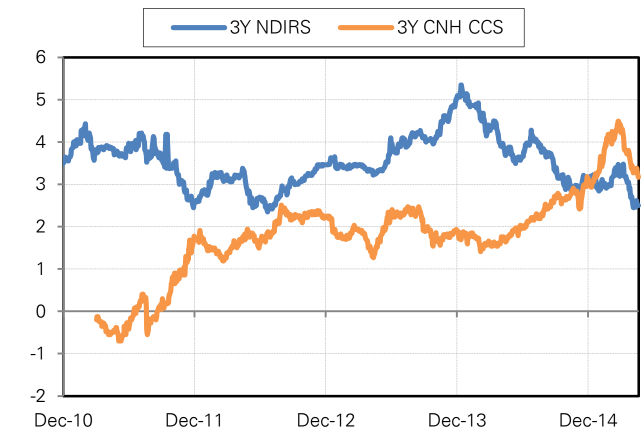
Moreover, in Q1 a significant amount of FX hedging on the back of sharp depreciation of the EUR vs. the USD and RMB pushed the CNH forward sharply higher (the type 1 flow discussed above). The combination of elevated offshore RMB funding (by FX swaps) and the narrowing of the onshore and offshore interest rate differential has reversed the dynamics between the onshore and offshore flows since the end of Q1.

Figure 72: Offshore risk-free rate is above onshore comparables (%)



Source: Deutsche Bank, Bloomberg Finance LP

Figure 73: NDIRS and CNH CCS (%)



Source: Deutsche Bank, Bloomberg Finance LP

First, carry-driven investment inflows have slowed down sharply YTD. In the past, borrowing offshore RMB at around 1% and investing in onshore CGBs or policy bank bonds (for example 10Y onshore CGB at 4.3% and 10Y CGB at 5.2% during the mid of last year) was the most popular carry trade. This year, onshore CNY bond investment no longer seems attractive following the strong rally last year and after taking off the credit and FX hedging costs. In March this year, foreigners' investment in onshore bonds was up 6% YoY YTD, vs. 33% YoY YTD in April 2014.

Secondly, demand for RMB cross border financing (borrowing offshore to invest onshore) has weakened as Chinese corporations can access cheap financing onshore. For example, in March an AA- rated global bank issued offshore RMB bonds at 4.6%, while at that time a highly rated Chinese corporation could get a 3Y bank loan onshore at the same level. In other words, the cost savings from offshore RMB bond financing no longer seemed appealing to borrowers with real RMB cash demand.

Thirdly, southbound trading under the Stock Connect program since late March has supplied RMB liquidity to Hong Kong as H-share stocks get more attractive relative to the A-share stocks. By design, the southbound trading supplies RMB liquidity into the offshore RMB market because the RMB conversion into HKD takes place in Hong Kong. Meanwhile, offshore investors began to take profits on their Northbound investments (investment into the A-share market) which repatriates RMB from the Mainland to the offshore market. Net balances between the aggregate Northbound trading and Southbound trading quota usage suggests about RMB46bn of cumulative liquidity supply to the offshore RMB market from late March to today. Furthermore, mainland investment inflows outside the Stock Connect program (to stocks which are not included in the Stock Connect program yet) also supplied RMB liquidity to the offshore market.

Fourthly, we expect RMB exchange rate to be stable in the near term, which will reduce the RMB depreciation risk premium priced in on the CNH CCS curve. We think (a) Prospective of RMB capital account liberalization this year is supportive to strategic capital inflows (long term investment) into China; (b) from a policy standpoint, we believe China prioritizes monetary and fiscal policies to stabilize economic growth and intends to keep RMB exchange rate policy unchanged.

Lastly, onshore liquidity will remain flush in Q2 following the interest rate cut on May 11th, moreover, we expect China accelerates capital account liberalization in the coming months, including liberalizing two-way capital flows, relaxing onshore RMB investment flows/financing flows to the offshore RMB market, all of these will improve China's monetary policy transmission to the offshore market, improve offshore liquidity and ease the risk of liquidity squeeze. We call for onshore 7D repo rate to stabilize around 2%, and onshore offshore basis rates in the money market to narrow.

Trading view: We have recommended trade the CNH CCS curve in a range with a bullish bias and have entered 1Y CCS receiving trade at 3.6% with a revised target of 2.6% from 2.9%.

Offshore RMB market policy update

On the policy front, the main theme since the start of this year has been China continuing to refine the offshore RMB clearing infrastructure and steadily expand the RMB QFII scheme globally. Two RMB clearing banks were appointed earlier this year (Thailand and Malaysia), and Switzerland and Luxembourg have received RMB50bn RQFII quota each.

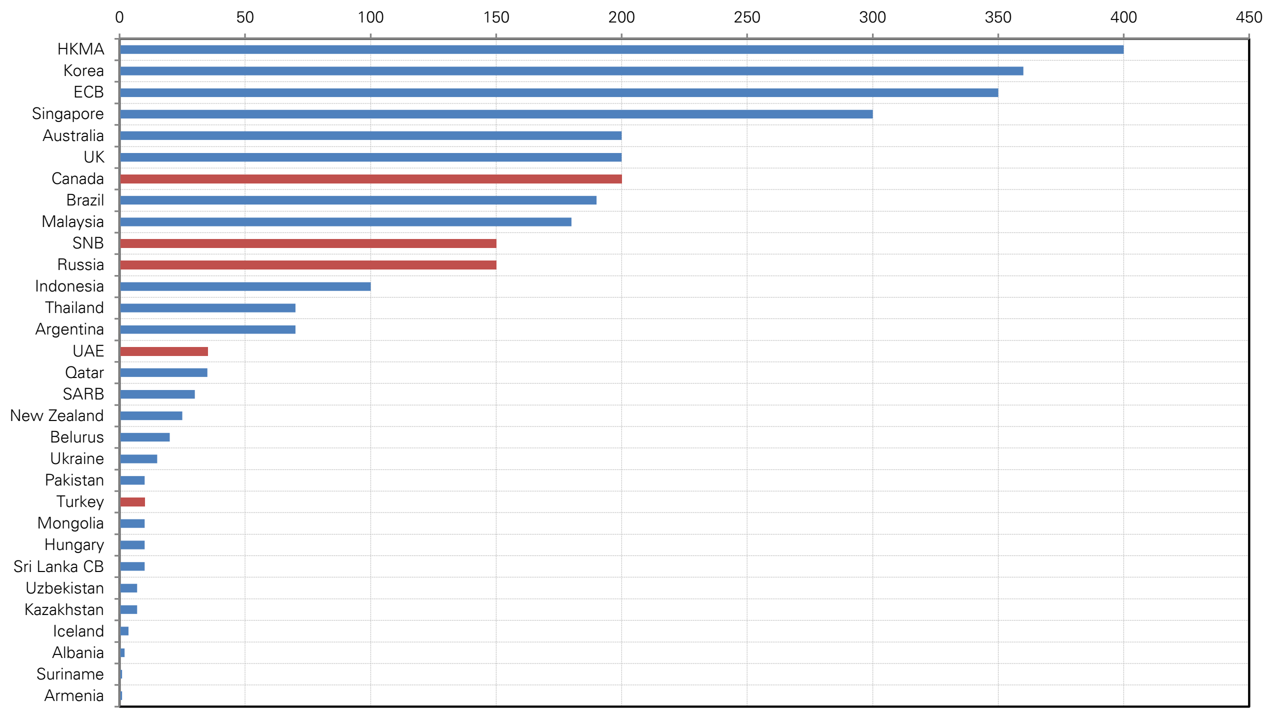
Figure 74: Key policies on offshore RMB market development

Date	Event
11-May-15	PBoC renewed RMB7bn cross currency swap agreement with Belarus
29-Apr-15	Luxembourg received RMB50bn RQFII quota
20-Apr-15	Silk Road fund made the first overseas investment
10-Apr-15	PBoC signed RMB30bn cross currency swap agreement with South African Reserve Bank
25-Mar-15	PBoC signed RMB1bn cross currency swap agreement with the central bank of Armenia
18-Mar-15	PBoC signed RMB1bn cross currency swap agreement with the central bank of Suriname
22-Jan-15	Switzerland received RMB50bn RQFII quota
6-Jan-15	PBoC appointed ICBC (Thailand) as the RMB clearing bank in Bangkok
5-Jan-15	PBoC appointed Bank of China (Malaysia) as the RMB clearing bank in Kuala Lumpur
22-Dec-14	PBoC signed MoU with BoT on RMB clearing arrangement
22-Dec-14	PBoC renewed RMB70bn cross currency swap agreement with Bank of Thailand

Source: Deutsche Bank, PBoC

During January to April, the PBoC signed/rolled RMB cross currency swap agreements with Bank of Thailand, Central Bank of Suriname, Central Bank of Armenia, South Africa Reserve Bank, and the Central Bank of Belarus with a total notional amount of RMB109bn. Currently, the PBoC has entered RMB cross currency swap agreements with 31 central banks globally with a total notional amount of RMB3139bn.

Figure 75: PBoC has extended RMB swaplines to 31 central banks globally (RMB bn)



Source: Deutsche Bank, PBoC

Offshore RMB fixed income market Q2 supply outlook

- Surging supply in Taiwan's RMB Formosa bond market

RMB bond issuance in Taiwan's Formosa bond market surged earlier this year thanks to the relaxation of insurers' investment restrictions. In the past, Taiwan insurers' investments in offshore RMB bonds counted towards their overseas investment quota. In February this year, however, Taiwan's financial regulator removed the Formosa bonds from insurers' overseas investment quota, i.e. Formosa bond investment is treated as domestic investment. Demand from insurers for medium to long dated RMB Formosa bonds led to strong supply of RMB Formosa bonds from global banks and corporations. On a YTD basis, we estimate the RMB Formosa bond net supply at close to RMB15bn, or 70% of the total offshore RMB net supply and 72% of the net RMB Formosa bond supply in 2014. Of major new offshore RMB bond placements completed YTD, we estimate insurers have bought about 37% of the new supply.

We believe there are three key market implications from recent developments in the RMB Formosa bond market:

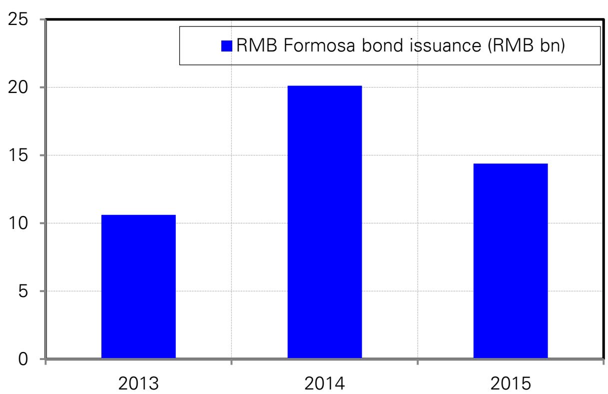
(a) RMB Formosa bonds account for a rising share of the offshore RMB bond market – currently about 6.3% of the offshore RMB fixed income market, up from 2% in 2013.

(b) RMB Formosa bonds have extended the duration of the offshore RMB bond yield term structure from the 3Y tenor up to the 30Y tenor. The weighted average life of RMB Formosa bonds was three years in 2013 and five years in 2014. In 2015 there have been a few placements in the 10Y+ tenors. Last year, the longest tenor was the sovereign China government bonds (CGB) in the 20Y tenor, and currently we have a 30Y bond by a global bank.

(c) It improves market activities at the long end of the CNH CCS curve. Because most of the RMB Formosa bond issuance was RMB swap-based financing, liability hedging in the CNH CCS market has been fairly active, even at long dated tenors.

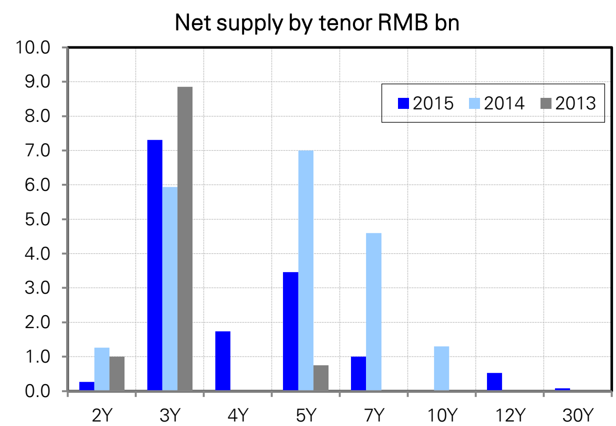
Considering Taiwan insurers' long-term asset allocation demand, market activity has largely been concentrated in the primary market, and trading in the secondary market is extremely limited. While we expect demand from Taiwan insurers to remain supportive for the RMB Formosa bond market, the recent rally in the CNH CCS curve has narrowed the potential cost savings for RMB swap-based borrowers. This suggests that RMB Formosa bond issuance is more likely to be driven by RMB financing (borrowers with real RMB cash demand) in the next few months.

Figure 76: Net supply in RMB Formosa market



Source: Deutsche Bank, Bloomberg Finance LP

Figure 77: Maturity extension in the RMB Formosa market



Source: Deutsche Bank, Bloomberg Finance LP

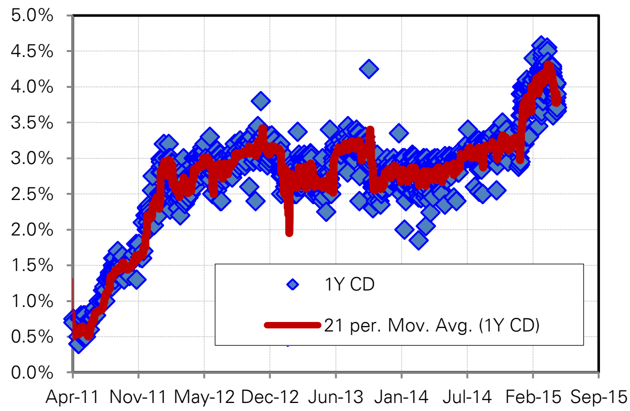
- Q2 supply outlook

The offshore RMB fixed income market had been under selling pressure since the start of the year. The average yield of the most liquid market tracked by the S&P DB CNH bond index rose by as much 90bps to 5.6% by the end of Q1. We believe there were two main reasons for the selloff in the offshore RMB bond market in Q1:

(a) Fear of RMB depreciation against the USD dominated the weak sentiment in the offshore RMB bond market in Q1. We think some of the selling in cash bonds was triggered by redemption at the offshore RMB real money funds (similar trend evident in the drop in the offshore RMB liquidity pool in Q1).

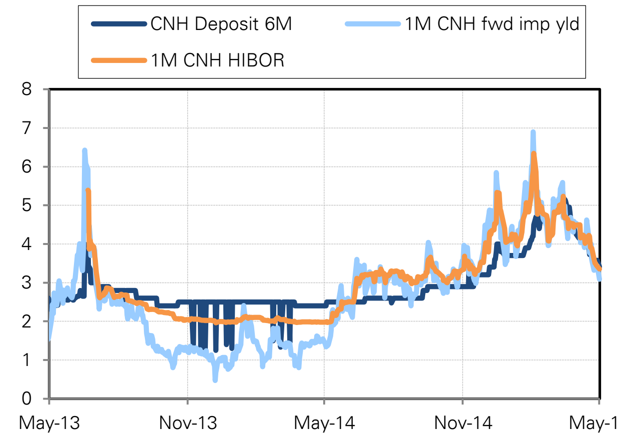
(b) Offshore RMB funding squeeze: A shrinking RMB deposit pool and the strong one-way buying flow on the USDCNH forward market pushed offshore RMB money market rates to unprecedented levels – from the end of 2014 to early February, 1M CNH forward implied yield climbed to around 9.2% from 3.5%, 1M CNH Hibor jumped to 6.35% from 4%, while the 1Y CD rate rose from 2.9% to 4.5%. Many leveraged positions in the offshore RMB bond market had to be unwound. Funding tightness also caused a sharp slowdown in offshore RMB bond supply – the net supply of bonds was only RMB22bn (mostly Formosa bonds), and there was RMB71bn net redemption of CDs in Q1.

Figure 78: Yield of offshore RMB CD in 1Y tenor



Source: Deutsche Bank, Bloomberg Finance LP

Figure 79: CNH money market rates (%)



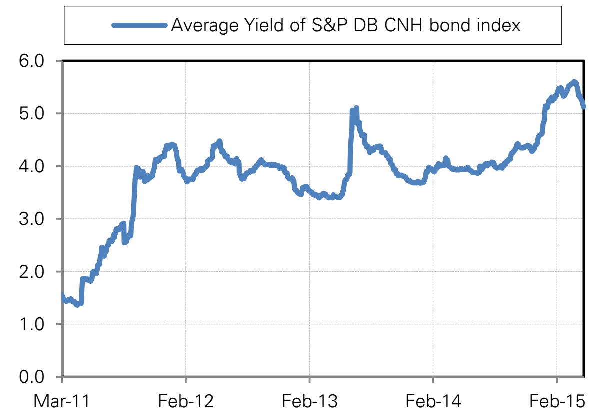
Source: Deutsche Bank, Bloomberg Finance LP

Relative performance in Q1 suggests that the offshore RMB sovereign/quasi sovereign bonds outperformed the offshore RMB credit bonds – the implied credit spread of the offshore RMB sovereign/quasi sovereign bonds (after taking out the currency risk via 3Y CNH CCS) narrowed by 64bps in Q1, while the implied spread of the offshore RMB credit market narrowed by 4bps.

Demand for cash bonds has recovered in both the primary and secondary market: Since the start of April, demand for offshore RMB cash bonds has begun to recover in both the primary and secondary market thanks to the stabilization of USDCNH spot and the easing of CNH funding conditions. The 1Y CD rate has fallen to around 3.5%, 1M CNH forward implied yield to 3.1%, and 1M CNH Hibor to 3.35% currently. The average yield of liquid offshore RMB bonds rallied by about 50bps, bringing the YTD total return to 0.81% in CNH terms and 1.05% in USD by the end of April 2015. Offshore RMB bond issuance resumed with recently placed deals heavily oversubscribed. Based on public statistics of major new deals YTD, we estimate that insurance and asset management funds absorbed about 71% of the gross supply, followed by banks (19%) and PB accounts (8%).

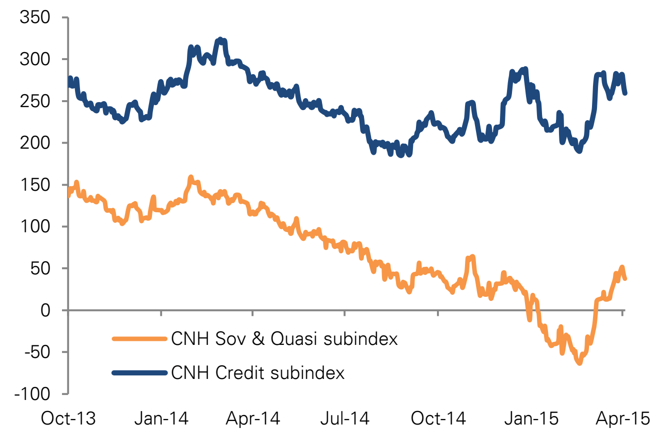
Q2 supply outlook: We expect RMB exchange rates to remain stable in the coming months and offshore RMB liquidity conditions to continue to ease along with onshore monetary policy easing. Such a policy backdrop should be supportive for the demand and supply balances in the offshore RMB market. We forecast Q2 net supply of offshore RMB bonds and CDs at RMB90bn. We expect both IG corporate names and sovereign/quasi sovereign names to outperform the high yield sector.

Figure 80: Average yield of the liquid offshore RMB bonds (%)



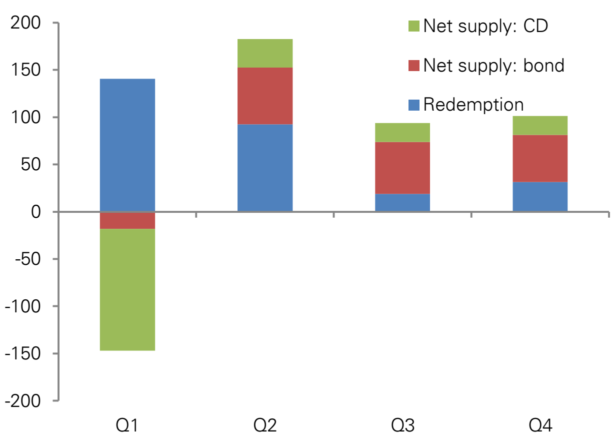
Source: Deutsche Bank

Figure 81: Implied credit spread (bps)



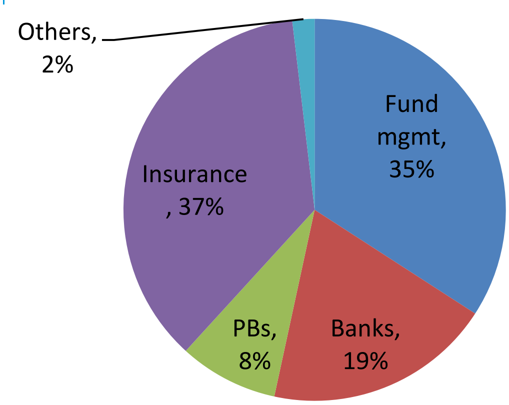
Source: Deutsche Bank

Figure 82: Offshore RMB market quarterly supply forecast (RMB bn)



Source: Deutsche Bank, Bloomberg Finance LP

Figure 83: Primary market demand breakdown



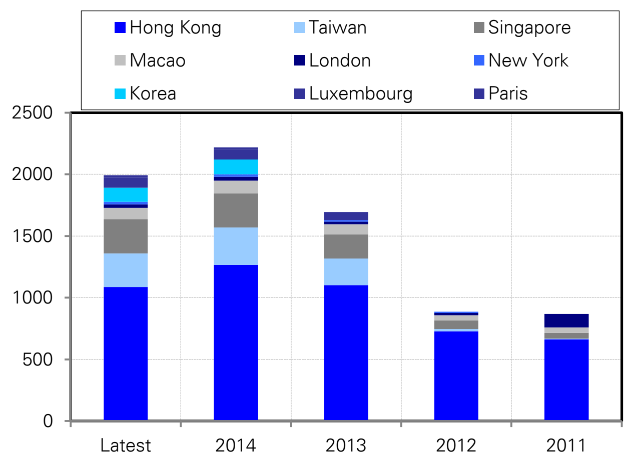
Source: Deutsche Bank estimates

Offshore RMB deposits fell to around RMB2trn in Q1 2015

We estimate that in Q1 2015, offshore RMB deposits fell by roughly 10.2% to around RMB2trn. The drop in RMB deposits was evident in many offshore RMB centers; in Hong Kong, for example, balances of cash deposits and certificate of deposits dropped by about 14% from the end of 2014. In Taiwan, Macau and South Korea, RMB deposits have fallen by approximately 5-10% YTD. In our view, the main reason for the reduction in offshore RMB deposits was concerns over USD strength against the offshore RMB, as the USDCNH spot rose from 6.2194 to 6.2893 during January to early March. Historically, changes in CNH valuation tend to be correlated with growth in offshore RMB deposits, as was the case in 2012, although structural drivers such as opening up the capital account and expanding RMB business to more offshore RMB centers tend to mitigate such negative effects.

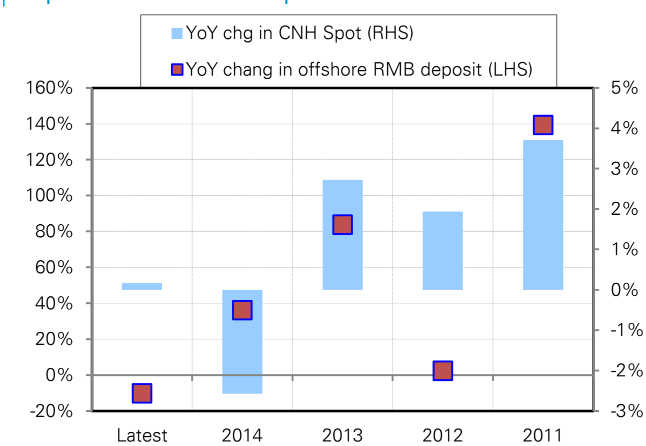
We expect offshore RMB deposit growth to recover from April till the end of the year for two reasons: (a) With clear indications from policy makers over the past few weeks that China does not want to depreciate the RMB, we expect USDCNH and USDCNY Spot to stabilize around the current levels for the next few months. (b) Offshore RMB bonds have begun to look attractive as concerns over currency risk have eased. (c) Equity market inflows (to invest in H-shares via the Stock Connect program) will also boost the RMB deposit base. (d) Offshore RMB business continues to expand, with the latest expansion of the RMB QFII program to more regions (Luxembourg most recently). We maintain our forecast that the offshore RMB deposit pool will grow 30% YoY to RMB3.25trn by the end of 2015, boosted by RMB investment and diversification demand from corporates, institutions, and foreign central banks.

Figure 84: Offshore RMB deposit balances drop in Q1 2015 (RMB bn)



Source: Deutsche Bank, various central bank websites

Figure 85: Change in CNH valuation contributed to the drop in offshore RMB deposits



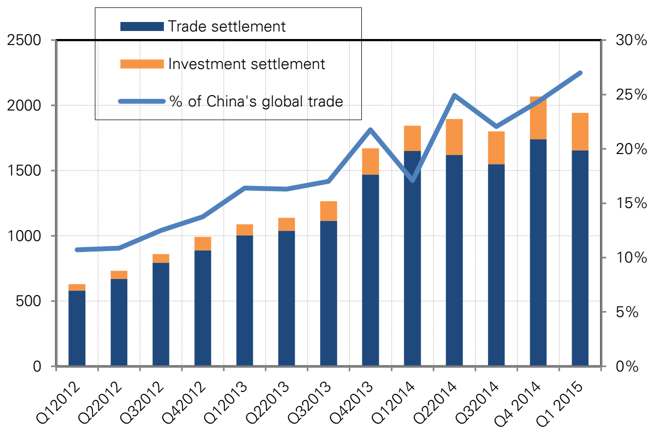
Source: Deutsche Bank, various central bank websites

RMB trade settlement rose to 27% of China's global trade in Q1 2015

In Q1 2015, RMB settlement volume grew by 5% YoY to RMB1943bn. RMB trade settlement volume was RMB1655bn, accounting for 85% of the RMB total settlement and up 0.2% YoY. In Q1, about 27% of China's global trade was settled in RMB, above our forecast of 25% for the full year 2015.

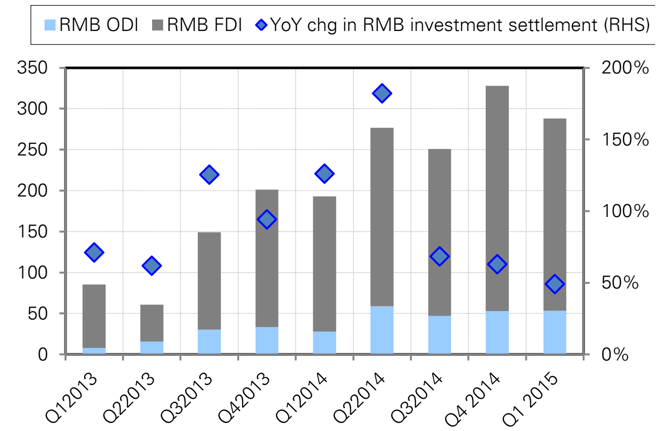
RMB investment settlement volume grew by 49% YoY to RMB288bn. As a share of RMB settlement, RMB investment settlement (FDI and ODI) rose to 15% in Q12015 from 13.78% in 2014. We expect RMB investment settlement to continue its strong growth going forward as China opens up its domestic capital market and relaxes control over the capital account. We expect the investment share to grow towards 20% of RMB total settlement volume by the end of 2015.

Figure 86: RMB trade settlement accounted for 27% of China's global trade in Q12015 (RMBbn)



Source: Deutsche Bank, PBoC

Figure 87: RMB investment settlement growth (RMB bn)



Source: Deutsche Bank, PBoC

Offshore RMB market turnover update

Offshore RMB activities were stable in Q12015 relative to Q42014. According to our estimates, daily turnover of RMB spot reached an average of USD7bn, in line with our expectation for full year 2015, and the offshore RMB forward market turnover was USD11bn excluding funding via T/N (otherwise would be around USD22bn), flat vs. the end of 2014. Turnover in the CNH CCS market was stable at around USD1.5-2bn per week. However, turnover in the CNY NDF market dropped to about USD1bn per day vs. USD2bn per day on average last year. Daily volume in the CNH FX option market was roughly USD2.5-3bn, unchanged from Q4 last year. We believe the stability of offshore RMB market turnover volume in Q1 suggests that the growth in RMB cross trade and investment settlement volumes has largely been offset by a reduction in offshore RMB capital market investment activities.

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Figure 88: Offshore RMB daily turnover

Spot	USD 6-8bn
Fwd	USD 10-12bn
CNH CCS	USD 1.5-2bn/week
NDF	USD 0.8-1bn
FX option	USD 2.5-3bn

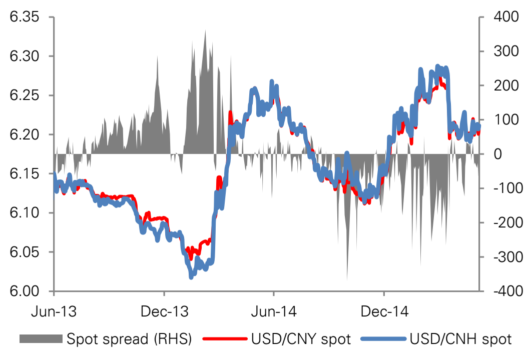
Source: Deutsche Bank estimates

Chart Pack

Spreads monitors

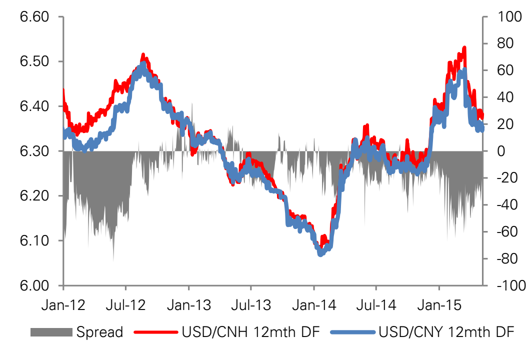
Cross-border spreads

Onshore vs. offshore spot



Sources: Bloomberg Finance LP and Deutsche Bank.

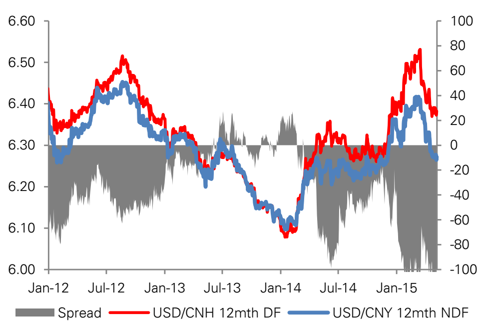
Onshore vs. offshore 12m deliverable forwards



Sources: Bloomberg Finance LP and Deutsche Bank.

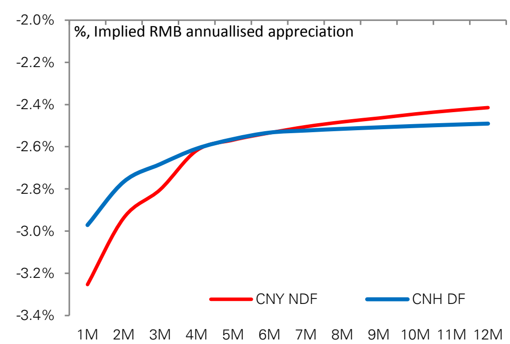
Offshore basis spreads

12m NDF vs. 12m offshore forwards



Sources: Bloomberg Finance LP and Deutsche Bank.

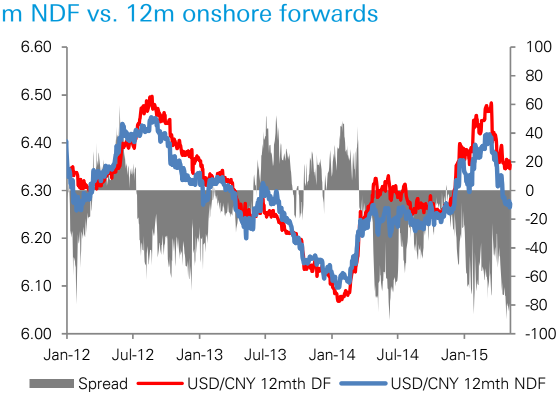
Implied appreciation NDF vs. CNH market*



Sources: Bloomberg Finance LP and Deutsche Bank.*using CNH spot for CNH forwards

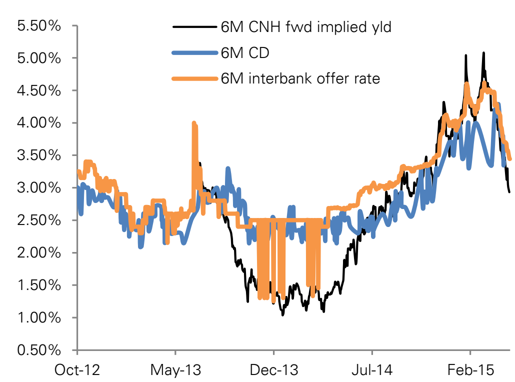
Onshore-offshore spreads

12m NDF vs. 12m onshore forwards



Sources: Bloomberg Finance LP and Deutsche Bank.

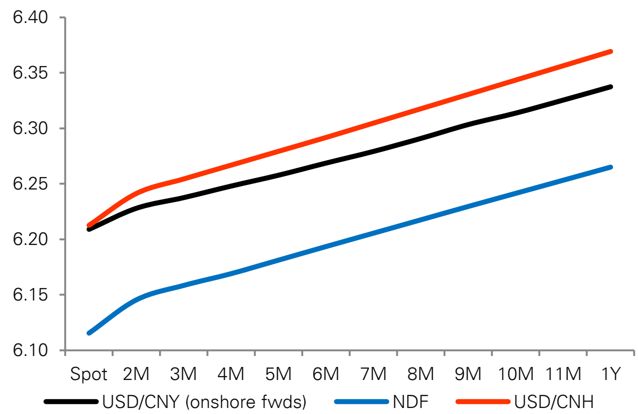
Offshore CNH funding rate (6m)



Sources: Bloomberg Finance LP and Deutsche Bank.

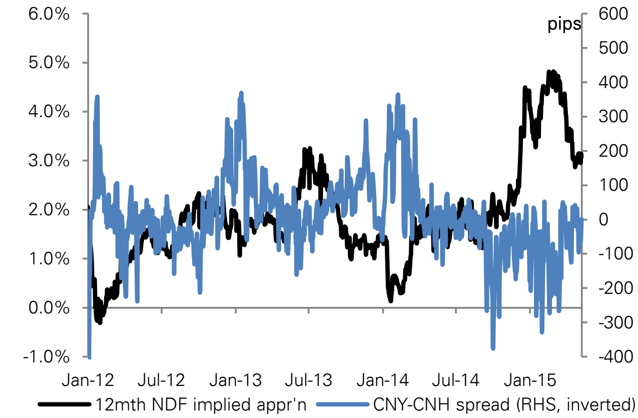
Cross-market comparisons

RMB forward curves in various centers



Sources: Bloomberg Finance LP and Deutsche Bank.

NDF implied appreciation vs. CNH-CNY spot spread

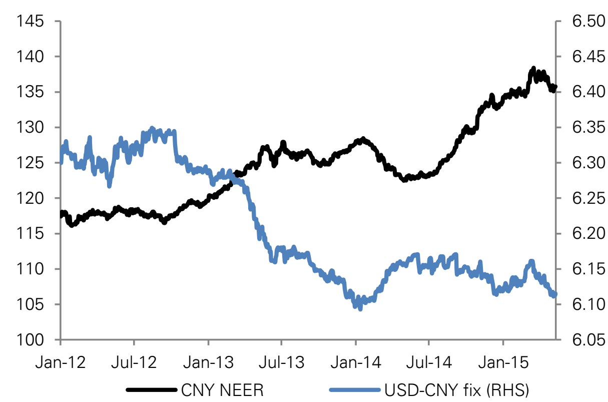


Sources: Bloomberg Finance LP and Deutsche Bank.

CNY NEER basket

Sources: Bloomberg Finance LP and Deutsche Bank.

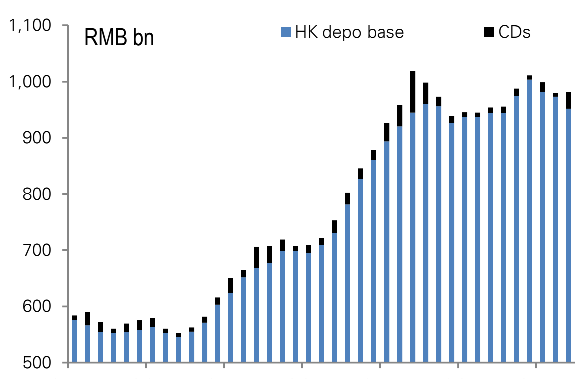
USD/CNY spot fixings vs. USD-currency basket of key trade partners



Sources: Bloomberg Finance LP and Deutsche Bank.

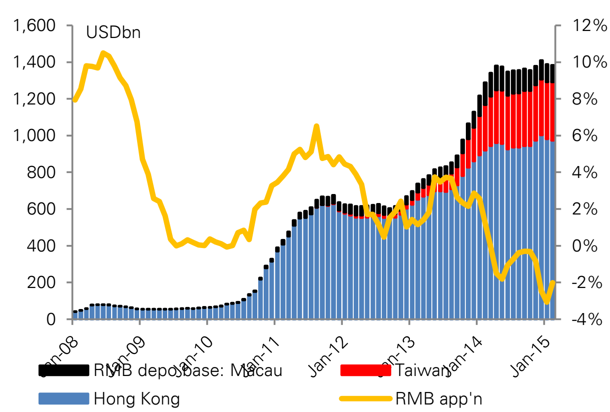
CNH deposit base

CNH deposit base in Hong Kong



Sources: Bloomberg Finance LP and Deutsche Bank.

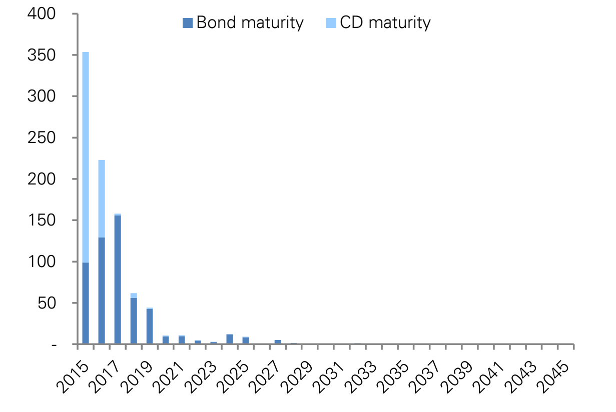
RMB spot vs. CNH deposit base



Sources: Bloomberg Finance LP and Deutsche Bank.

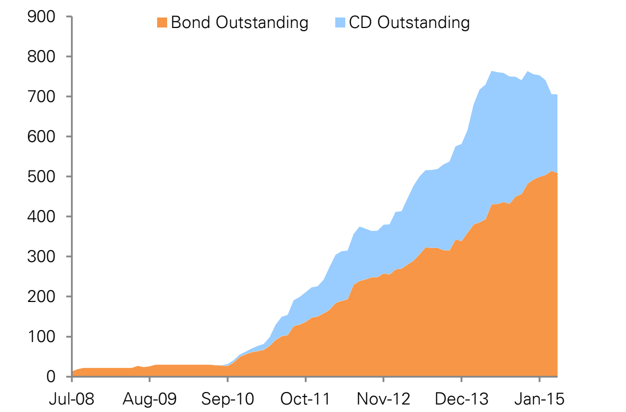
Offshore RMB bond issuance and total return monitor

Offshore RMB bond maturity profile (RMB bn)



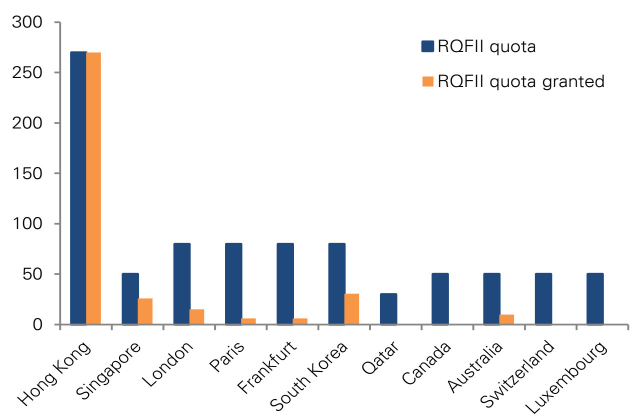
Source: Deutsche Bank, company data

Offshore RMB fixed income market size (RMB bn)



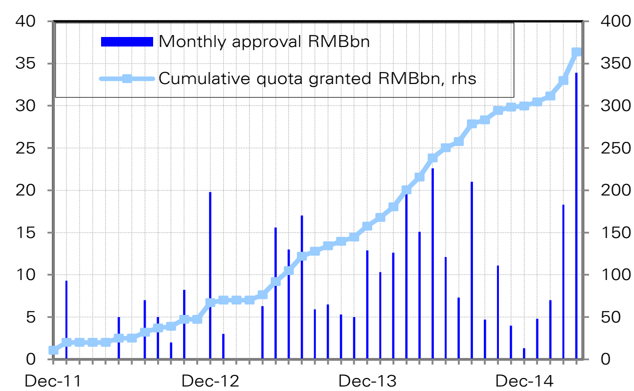
Source: Deutsche Bank, company data

RQFII quota and approval (RMB bn)



Sources: Deutsche Bank, HKMA, PBoC

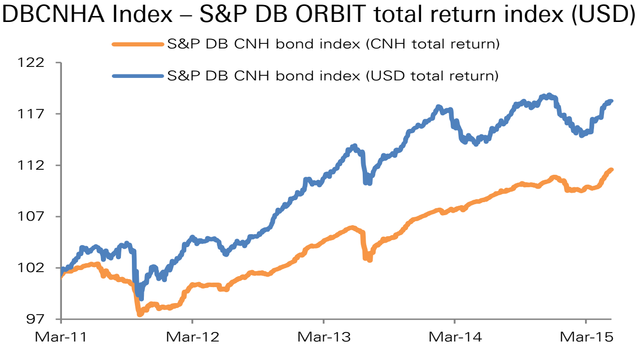
RQFII monthly approval (RMB bn)



Sources: Deutsche Bank, HKMA, Bloomberg Finance LP

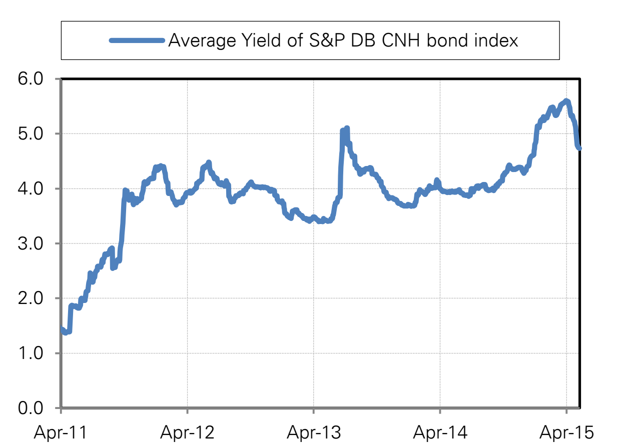
S&P DB ORBIT (CNH Bond) Total Return Index

Index Code on Bloomberg:
DBCNH Index – S&P DB ORBIT total return index in CNH
DBCNHA Index – S&P DB ORBIT total return index (USD)



Source: Deutsche Bank, Bloomberg Finance LP

S&P DB ORBIT Index (average yield %)



Source: Deutsche Bank, Bloomberg Finance LP

Offshore RMB market asset tracker

Asset type	Outstanding amount RMB bn	Average life
CNH bonds/CDs	711	2.28yrs
Sovereign, Quasi-Sovereign, Supranationals	134	
Bank, Insurance	388	
Corporates	190	
CNY bond access	1200	
RQFII access	364	
CNH equities	56	
Total	1665	

Source: Deutsche Bank

Appendix 1

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