



## Economic Insight

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## Bond Connect and China's interest rate outlook

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- To facilitate the development of bond markets in Hong Kong and Mainland China, PBOC and HKMA jointly announced on May 16 that the Bond Connect has been officially approved. In the initial phase, the Northbound Trading will commence first.
- Compared to the previous opening measures, Bond Connect is more in line with international practice. With almost no access threshold, the scheme can greatly reduce the transaction cost.
- We expect foreign institutional investors to invest in bonds issued by the central government and policy banks in the initial stage so as to control credit risks.
- The PBOC is expected to keep benchmark interest rates steady in 2017. Interest rate in the financial market, however, will rise moderately with the ongoing economic deleveraging and tightening financial regulatory measures.

### Bond Connect to launch soon

To facilitate the development of bond markets in Hong Kong and Mainland China, PBOC and the HKMA jointly announced on May 16 that the Bond Connect has been officially approved. In the initial phase, the Northbound Trading will commence first. The Chinese regulators published the draft rules and solicited public feedbacks for the Bond Connect on June 12. Following that, they released the temporary rules for the scheme on June 21. Although the formal launch date has not been announced, we expect the operation to start in 3Q17 or as early as July.

According to the draft rules of the Bond Connect, eligible foreign investors will include the central banks and other medium and long-term institutional investors, which are similar to those eligible for direct access to the China's Interbank Bond Market. Trading will occur via cash bond transactions, and eligible foreign investors will be able to trade various RMB-denominated bonds available in the China Interbank Bond Market, including the government bonds, financial bonds, corporate bonds, interbank deposits, and asset-backed securities. Meanwhile, both the minimum bond quotation request amount and the minimum bond change unit must be CNY 1mn.

Compared to the previous opening measures, Bond Connect is more in line with the international practice. With almost no access threshold, the scheme can greatly reduce transaction cost. Its implementation will boost China's bond trading volume and increase demand for the country's bonds, hence attracting capital inflows while easing the outflow pressure.

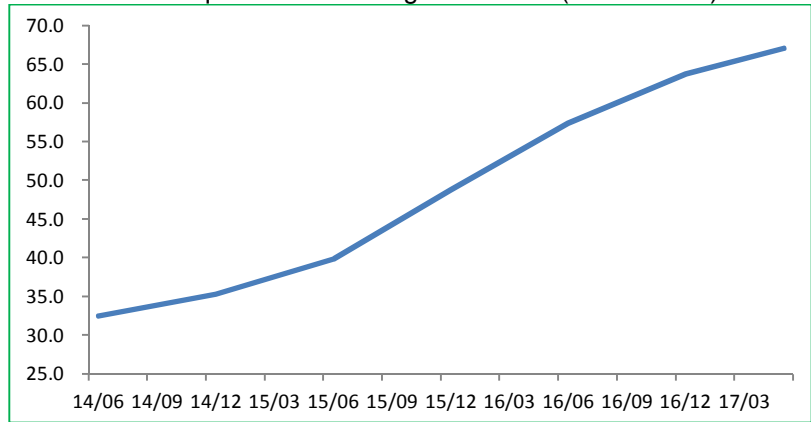
China's bond market is the 3<sup>rd</sup> largest in the world after the U.S. and Japan. Its market size has been growing by 21%<sup>1</sup> in the last 5 years. As of May 2017, China's total outstanding bond size amounted to CNY 67.1tr, of which ~1.2% were held by foreign investors (Exhibit 1).

<sup>1</sup> All growth rates are year-on-year except specified otherwise



Thus, the potential of Bond Connect will be enormous given the weight of RMB in the SDR basket of currencies is at 10.92%.

Exhibit 1: China's total outstanding bonds size (CNY Trillion)



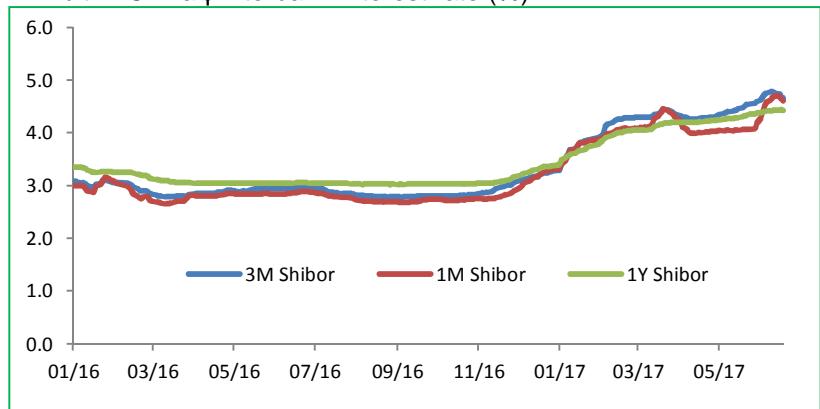
Source(s): PBOC, ABCI Securities

To minimize credit risks, we expect foreign institutional investors to invest in bonds issued by the central government and policy banks in the initial stage of Bond Connect. Market interest rate will be crucial in determining the investment return of Bond Connect investors.

**China's interest rate outlook**

With the ongoing economic deleveraging and tightening financial regulatory measures, China's interest rate in the financial market has risen since the start of 2017(Exhibit 2). According to BIS statistics, China's total debt-to-GDP ratio reached 257.0% in 2016, compared with 244.9% in 2015 (Exhibit 3). In particular, the corporation debt-to-GDP ratio was 166.3% at end-2016, which is way higher than that in advanced countries. However, the country's benchmark interest rate has remained unchanged given that economic conditions remain challenging.

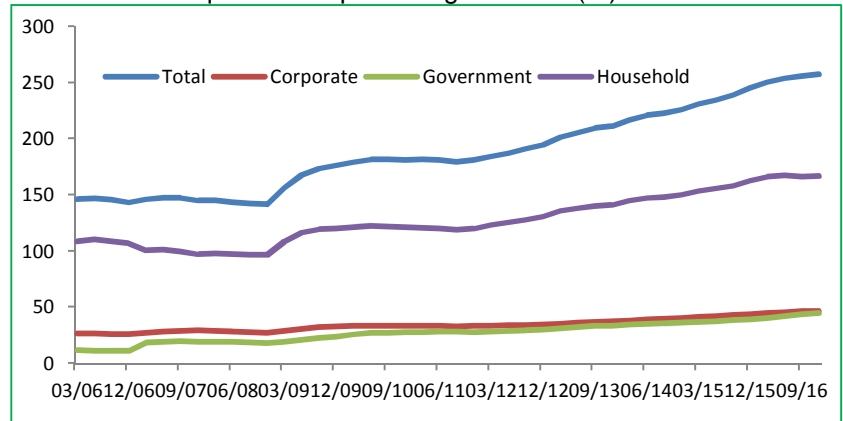
Exhibit 2: China's interbank interest rate (%)



Source(s): Bloomberg, ABCI Securities



Exhibit 3: China's debt as a percentage of GDP (%)



Source(s): BIS, ABCI Securities

Looking ahead, although interest rate in the financial market is likely to rise in coming months, we believe a significant increase is unlikely.

Domestically, PBOC will uphold a stable and neutral monetary policy throughout 2017 and is expected to keep a good balance between deleveraging and maintaining a steady liquidity condition. Although PBOC will continue to deleverage and strengthen financial regulation, the implementing intensity would be mild as high interest rates in the financial market will weigh on the real economy and economic growth.

Externally, we expect the major central banks will adhere to an accommodative stance to counteract against economic and financial risks. Although the Fed has increased interest rate twice since the beginning of 2017, we expect the U.S. to hold interest rate unchanged in the remainder of 2017 with the weakening outlook for inflation and uncertainties surrounding Trump's active fiscal policy. The Fed is likely to start reducing its balance sheet by early 2018. ECB, BOJ and BOE are expected to continue with the easing monetary policy in coming quarters.

We expect PBOC to keep benchmark interest rates steady in 2017, while interest rate in the financial market is likely to rise moderately. The central bank will continue to deploy measures such as standing lending facility, medium-term lending facility, and pledged supplementary lending to maintain sufficient liquidity in the banking system. Regarding the exchange rate, we expect spot USD/CNY rate to approach 6.90 by end-2017 with Fed's moderate interest rate hike, as compared to 6.9450 at end-2016.



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**China Economic Indicators**

	2016										2017			
	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	Jan	Feb	Mar	Apr	May
Real GDP (YoY %)	---	---	6.7	---	---	6.7	---	---	6.8	---	---	6.9	---	---
Export Growth (USD, YoY %)	(1.8)	(4.1)	(4.8)	(4.4)	(2.8)	(10.0)	(7.3)	0.1	(6.1)	7.9	(1.3)	16.4	8.0	8.7
Import Growth (USD, YoY %)	(10.9)	(0.4)	(8.4)	(12.5)	1.5	(1.9)	(1.4)	6.7	3.1	16.7	38.1	20.3	11.9	14.8
Trade Balance (USD bn)	45.6	50.0	48.1	52.3	52.1	42.0	49.1	44.6	40.8	51.3	(9.1)	23.9	38.0	40.8
Retail Sales Growth (YoY %)	10.1	10.0	10.6	10.2	10.6	10.7	10.0	10.8	10.9	9.5	9.5	10.9	10.7	10.7
Industrial Production (YoY %)	6.0	6.0	6.2	6.0	6.3	6.1	6.1	6.2	6.0	6.3	6.3	7.6	6.5	6.5
PMI - Manufacturing (%)	50.1	50.0	49.9	50.4	50.4	50.4	51.2	51.7	51.4	51.3	51.6	51.8	51.2	51.2
PMI - Non-manufacturing (%)	53.1	53.7	53.9	53.5	53.7	53.7	51.2	50.9	51.9	54.6	54.2	55.1	54.0	54.5
FAI (YTD) (YoY %)	10.5	9.6	9.0	8.1	8.1	8.2	8.3	8.3	8.1	8.9	8.9	9.2	8.9	8.6
CPI (YoY %)	2.0	1.9	1.8	1.3	1.9	1.9	2.1	2.3	2.1	2.5	0.8	0.9	1.2	1.5
PPI (YoY %)	(2.8)	(2.6)	(1.7)	(0.8)	0.1	0.1	1.2	3.3	5.5	6.9	7.8	7.6	6.4	5.5
M2 (YoY %)	11.8	11.8	10.2	11.4	11.5	11.5	11.6	11.4	11.3	11.3	11.1	10.6	10.5	9.6
New Lending (RMB bn)	556	986	1380	464	949	1220	651	795	1040	2030	1170	1020	1100	1110-
Aggregate Financing (RMB bn)	751	660	1629	488	1470	1720	896	1740	1630	3740	1150	2120	1390	1060

**World Economic/Financial Indicators**

Equity Indices				Global Commodities				Bond Yields & Key Rates			
	Closing price	Chg. WTD (%)	P/E	Unit	Price	Chg. WTD (%)	Volume (5-Day avg.)		Yield (%)	Chg. WTD (Bps)	
<b>U.S.</b>				<b>Energy</b>				US Fed Fund Rate	1.25	0.00	
DJIA	21,410.03	0.12	18.83	NYMEX WTI	USD/bbl.	42.41	(5.21)	383,605	US Prime Rate	4.25	0.00
S&P 500	2,435.61	0.10	21.61	ICE Brent Oil	USD/bbl	44.67	(5.70)	304,697	US Discount Window	1.75	0.00
NASDAQ	6,233.95	1.34	33.17	NYMEX Natural Gas	USD/MMBtu	2.90	(4.58)	145,284	US Treasury (1 Yr)	0.8370	0.52
MSCI US	2,319.85	0.10	22.03	China Qinhuangdao Port Thermal Coal <sup>2</sup>	USD/Metric Tonne	61.80	N/A	N/A	US Treasury (5Yr)	1.7615	1.82
<b>Europe</b>				<b>Basic Metals</b>				US Treasury (10 Yr)	2.1494	(0.20)	
FTSE 100	7,428.84	(0.46)	32.26	LME Aluminum Cash	USD/MT	1,857.75	0.09	33,192	Japan 10-Yr Gov. Bond	0.0580	0.20
DAX	12,749.60	(0.02)	20.48	LME Aluminum 3 -mth. Rolling Fwd.	USD/MT	1,867.00	0.00	39,560	China 10-Yr Gov. Bond	3.5440	(3.40)
CAC40	5,257.04	(0.12)	19.46	CMX Copper Active	USD/lb.	5,724.50	1.39	11,298	ECB Rate (Refinancing)	0.00	0.00
IBEX 35	10,697.20	(0.58)	16.82	LME Copper 3- mth Rolling Fwd.	USD/MT	5,742.00	1.40	35,371	1-Month LIBOR	1.2156	0.33
FTSE MIB	20,974.73	0.16	N/A	<b>Precious Metals</b>				3 Month LIBOR	1.2872	1.37	
Stoxx 600	387.72	(0.23)	24.87	CMX Gold	USD/T. oz	1,254.60	(0.15)	187,952	O/N SHIBOR	2.8690	1.62
MSCI UK	2,162.63	(0.29)	33.20	CMX Silver	USD/T. oz	16.66	(0.36)	23,912	1-mth SHIBOR	4.6070	(9.20)
MSCI France	151.17	0.25	19.30	NYMEX Platinum	USD/T. oz	931.70	0.53	16,242	3-mth HIBOR	0.7700	0.46
MSCI Germany	157.68	0.18	20.54	<b>Agricultural Products</b>				Corporate Bonds (Moody's)			
MSCI Italy	58.68	0.38	N/A	CBOT Corn	USD/bu	376.25	(4.02)	98,482	Aaa	3.61	(6.00)
<b>Asia</b>				CBOT Wheat	USD/bu	476.75	(0.99)	72,030	Baa	4.43	1.00
NIKKEI 225	20,110.51	0.84	19.23	NYB-ICE Sugar	USD/lb.	13.26	(2.71)	55,957			
S&P/ASX 200	5,705.95	(1.18)	19.43	CBOT Soybeans	USD/bu.	927.50	(2.37)	61,666			
HSI	25,704.29	0.30	13.84								
HSCEI	10,425.59	0.39	8.60								
CSI300	3,590.34	2.03	15.76								
SSE Composite	3,147.45	0.78	16.66								
SZSE Composite	1,862.84	(0.17)	27.41								
MSCI China	73.31	1.88	15.77								
MSCI Hong Kong	14,365.33	0.15	14.54								
MSCI Japan	958.26	0.91	16.75								

Note:

1. Data sources: Bloomberg, National Bureau of Statistics of China, ABCIS (updated on date of report)
2. The price is Coal 5500 kcal/kg FOB Spot Price

**Currency**

	Euro/USD	GBP/USD	AUD/USD	USD/JPY	USD/CHF	USD/CNY	USD/HKD	USD/CNY NDF 12-mth Spot pr.
Spot Rate	1.1163	1.2663	0.7550	111.08	0.9725	6.8326	7.7996	7.0100
Chg. WTD (%)	(0.31)	(0.94)	(0.93)	(0.18)	0.08	(0.32)	0.02	(0.24)



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### Definition of equity rating

Rating	Definition
Buy	Stock return $\geq$ Market return rate
Hold	Market return - 6% $\leq$ Stock return < Market return rate
Sell	Stock return < Market return - 6%

Stock return is defined as the expected % change of share price plus gross dividend yield over the next 12 months

Market return: 5-year average market return rate

Time horizon of share price target: 12-month

### Definition of share price risk

Rating	Definition
Very high	$2.6 \leq$ 180 day volatility/180 day benchmark index volatility
High	$1.5 \leq$ 180 day volatility/180 day benchmark index volatility < 2.6
Medium	$1.0 \leq$ 180 day volatility/180 day benchmark index volatility < 1.5
Low	180 day volatility/180 day benchmark index volatility < 1.0

We measure share price risk by its volatility relative to volatility of benchmark index. Benchmark index: Hang Seng Index.

Volatility is calculated from the standard deviation of day to day logarithmic historic price change. The 180-day price volatility equals the annualized standard deviation of the relative price change for the 180 most recent trading days closing price.

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