China Bond Market under Pressure

December rate hike well expected, yet rate hikes in 2017 surprises

This Wednesday, Dec 14th, the Federal Open Market Committee increased the federal funds rate by 25 basis points, to a range of 0.50 % to 0.75 %. This rate hike marked the second US rate hike in a decade time and it came as no surprise to the markets. Implied odds of a rate hike, based on fed funds futures, were 100 percent. However, a somewhat hawkish tone was sounded as projections that there could be three more hikes in 2017, as opposed to previous indications of just two.

The effect of the changing of tone was immediate. It put the brakes on Dow's rally towards the 20000 level, pushing US 10 Year Treasury Yield higher to 2.6% and sending the Dollar to its strongest level against Euro since 2002, close to parity.

Bond markets undergoing correction since Oct, US rate hike a double whammy

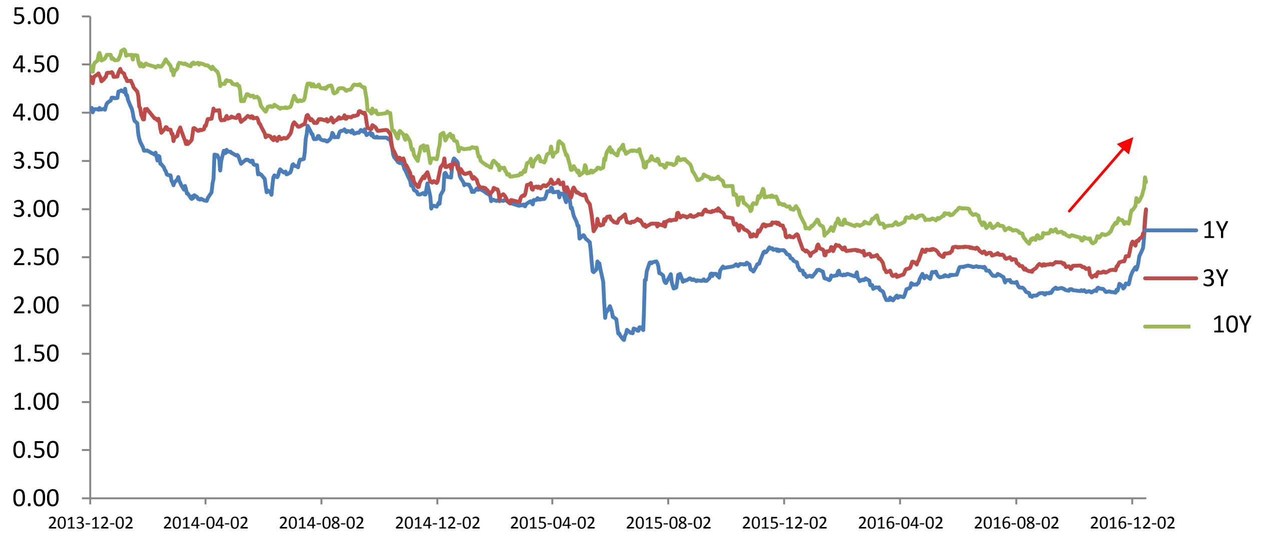
On December 15, 2016, as soon as the Federal Reserves increased interest rates, the Chinese bond market experienced significant corrections. The market scrambled as the Treasury Futures experienced its first limit down. Since the Treasury Futures experienced its largest single day drop on November 29th due to liquidity issues, the bond market experienced another major correction on December 15th. Rate bond interest rates increased by over 10 bps as soon as the market opened.

At market close, the 10-year government bond and most active CDB bonds yields increased 12 bps and 20bps to 3.36% and 3.89% respectively, a record increase, as a retreat in the RMB and the hawkish Fed outlook damped expectations around monetary easing in China.

Targeted Policy tightening -A key catalyst

Under the inverted funding cost vis-à-vis investment return for the most part of 2016, institutions investors had to resort to maturity mismatch and liquidity mismatch to enhance return. In a market environment where liquidity is abundant, the methodology offers relatively steady returns. Recently, a series of regulatory actions were taken to return off-balance-sheet assets back to the bank balance sheets. The PBOC now require banks to consider off-balance-sheet assets into the Macro Prudential Assessment (MPA) system, while the CBRC has published the "Risk Management Guidance on Off Balance Sheet Assets of Commercial Banks" to specify asset requirements. In addition, as portfolio managers exit positions to realize their gain for the year, the bond market's liquidity was significantly reduced. Money market funds, bond funds, and interbank financing channels are facing significant redemptions and thus pushed up short-term financing costs. The selling initiated from short-duration, high grade bonds and extended to long-duration rate bonds and corporate bonds.

Exhibit1: China Treasury Yield Rising Sharply since October



Source: Wind as of Dec 15, 2016

Aggregation of multiple factors, rising interest rates inevitable

Although the rate hike on December 15th was expected, the market did not expect as many as three anticipated rate hikes in 2017. The strength of the USD exacerbated the depreciation of the RMB, and exerted pressure on the onshore funds. As US treasury yields increased, the yield spread between US and China dropped and caused capital to unwind.

Secondly, since Q3' 2016, the government has switch its focus from steady growth to risk prevention. Monetary policy maintained a tight balance while the PBOC utilized financial instruments to provide liquidity rather than reducing reserve ratios. On the other hand, the delivery period of MLF and OMO instruments increased and resulted in the rise of interest rates, higher volatility in capital availability, and increased cost of borrowing of commercial banks. These factors ultimately led to the deleveraging of the bond market.

Furthermore, November economic data was published this week, which indicated steady investments in the short-term and high commodity prices resulted in rebound of inflation numbers. The lack of fundamental support for the bond market also meant that the current bond market correction is unlikely to be reversed over the short-term. In addition, the aggregation of multiple factors including the market's concerns over transaction defaults of institutional investors has resulted in the capitulation on the bond market on December 15th, which spiked up the short-term interest rates.

Patience is gold for the year to come

Short-term panic may gradually dissipate

Dec 15, 2016, The PBOC via Open Market Operation (OMO) injected a net total of 145 Billion of liquidity into the market amid tightened liquidity and challenges faced by non-bank Financial Institutions to get funding. Yet, with external shocks, depreciation pressure on the currency mounted. Foreign exchanges needs from the year end and beginning of next year coupled with demand for cash ahead of the Chinese Lunar New Year spell the double whammy for liquidity and in turn, the bond market. In the short team, yield on 10 year treasury could touch as high as 3%-3.4% range.

View towards current yield levels

This correction was largely driven unanimous action by market participant amid the outbreak of fear as both the velocity as well as magnitude of yield climb crushing market expectations. As a result, it is highly likely that the yield uptick may over shoot. Also worth noting, current economic fundamentals, both domestic and abroad, expected / real inflation levels and monetary policy stance have all, on a marginal basis, changed significantly. Hence the upward shifting of yields is merited. Our model and relative valuation against other asset classes have pointed to a 3%-3.3% yield level for 10 years treasuries. Allocation value is visible against currently yield levels.

Swift rebound unlikely , but weakening provide bolster

Looking ahead, fundamentals in 2017 does not warrant a bull market in bonds in the short term. For the most part of the year ahead, we foresee range bound yield movements. However, worth noting, domestic growth has already marginally weakened, evidenced by decline in real estate investment. Opportunities in the bond market shall re-emerge as domestic growth further weakens and monetary policy again returns to the neutral to easing stance.

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