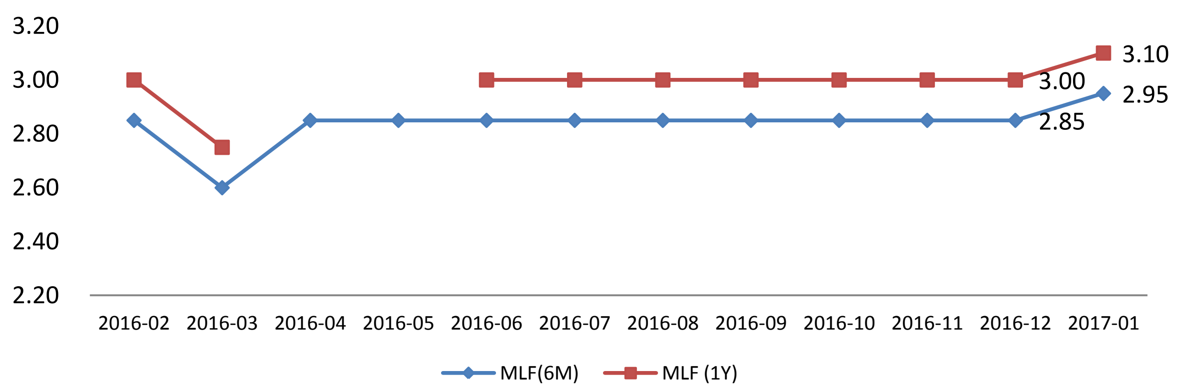
Tapering underway

PBoC Turns to Tapering

The year of Rooster is off to a bumpy start for the China fixed income market.

On Jan 24th , just a few days before the Nation's most celebrated holiday-the Chinese Lunar New Year, PBoC announced that it had injected 245.5 Billion RMB via MLF (Medium-term Lending Facility) operation. Of which 138.5 Billion RMB and 107 Billion RMB were lent on the tenure of 6 months and 1 year at interest rate of 2.95% and 3.1% respectively. The 10 bps hike in interest rate spooked the market and led to sell off in the treasury futures market.

Exhit1: MLF rate hike signals end of easing, at least for now



Source: Wind, ChinaAMC as of Feb 6, 2017

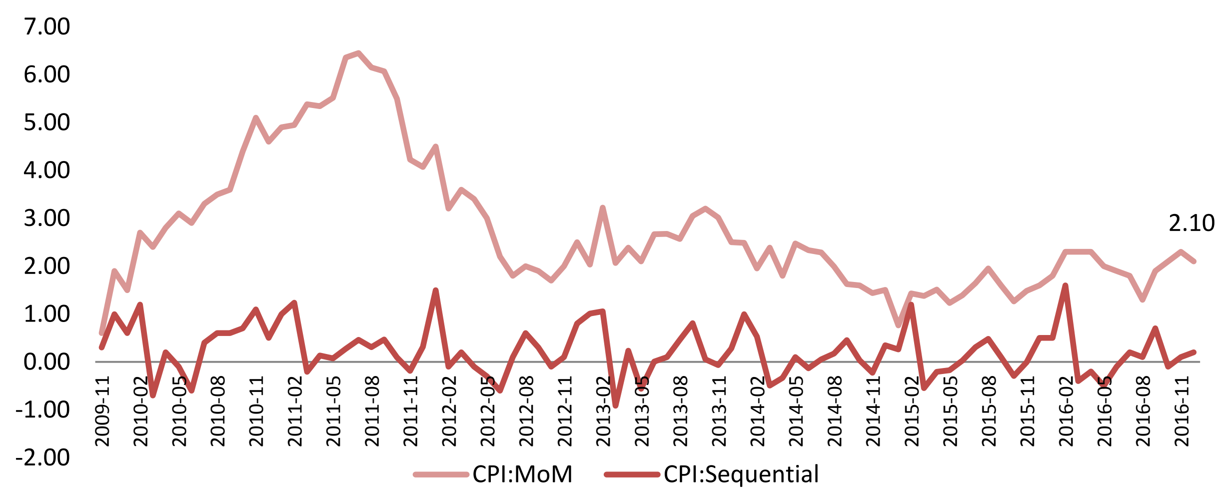
On Feb 3rd, PBoC further raised the 7-day, 14-day and 28-day reverse repo rate to 2.35%, 2.50% and 2.65% respectively. The overnight, 7–day and 1-month SLF (Short-term Lending Facility) rates have also been lifted to 3.10%, 3.35% and 3.70%. These actions reinforced the earlier Jan 24th signal to end monetary easing by the central bank.

Reasons to Tapering

1. Inflationary expectation emerge

December CPI fell slightly to 2.1% on a Year on Year basis, a level which was a bit shy from market consensus. CPI monthly change increased 0.2%, owing to weakness in food prices caused by weather conditions.

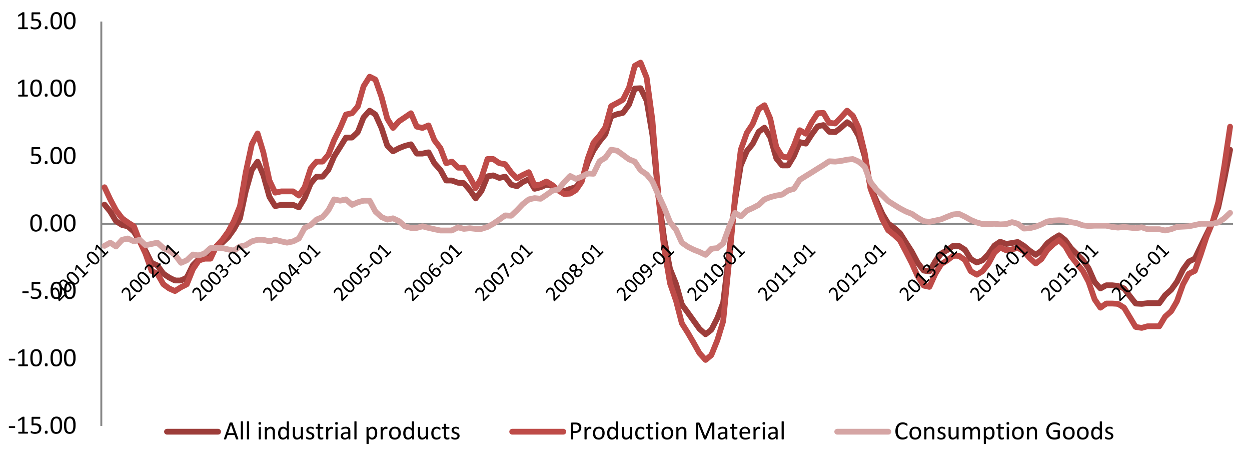
Exhibit 2: CPI extended it rebound



Source: Wind, ChinaAMC as of Feb 6, 2017

Other non-food sectors have recorded mild increases. The price recovery was transmitted from PPI to CPI. Transportation and telecommunication rose on the back of rising energy prices, and residential sector rose because of the higher hydro prices. Consumer upgrade also delivered solid results, (home service 0.5% and healthcare 0.5%).

Exhibit 3: PPI surprised to the upside



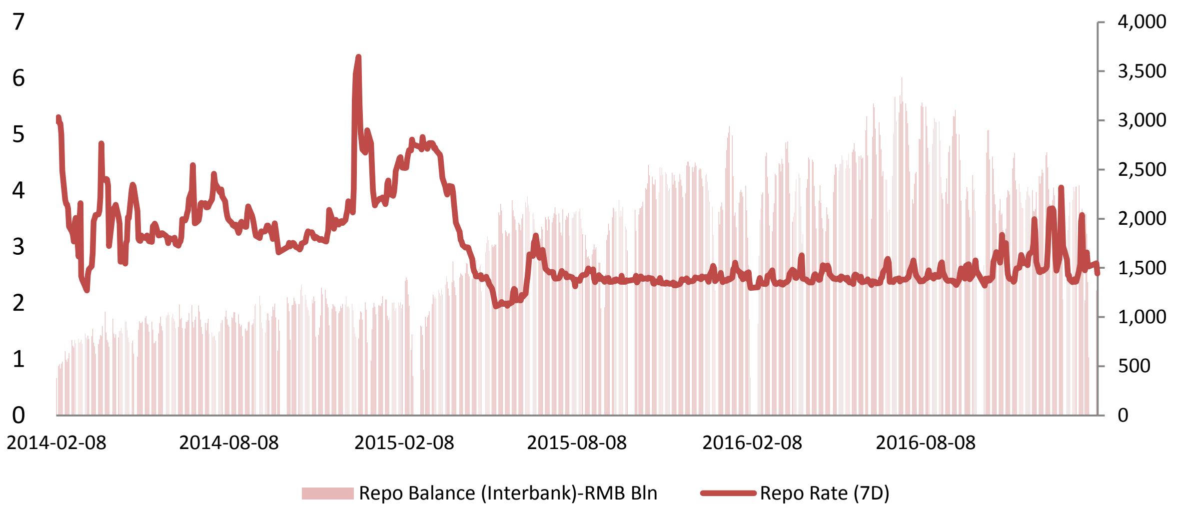
Source: Wind, ChinaAMC as of Feb 6, 2017

PPI accelerated its upward swing， MoM growth of 5.5% marked the new high since Sep 2011. The comeback was on the back of the supply-side reform, stabilized demand and the strengthening of production materials prices as RMB depreciation imported inflation.

2. Deleveraging is the paramount task

In his New Year message, PBoC Governor Mr.Zhou Xiaochuan highlighted the upcoming monetary policy to be “Prudent and Neutral” and “De-leverage and de-risk” to remain the key policy target for the year to come. In January of 2017, PBoC announced the inclusion of off-balance sheet non-cash wealth management products into the (Macro Prudential Assessment) MPA system. The move seeks to suppress commercials banks‘ room for off-balance maneuver, part of “shadow banking” and a source of risk. The goal is to and forces banks to re-focus on balance sheet backed lending to the real economy.

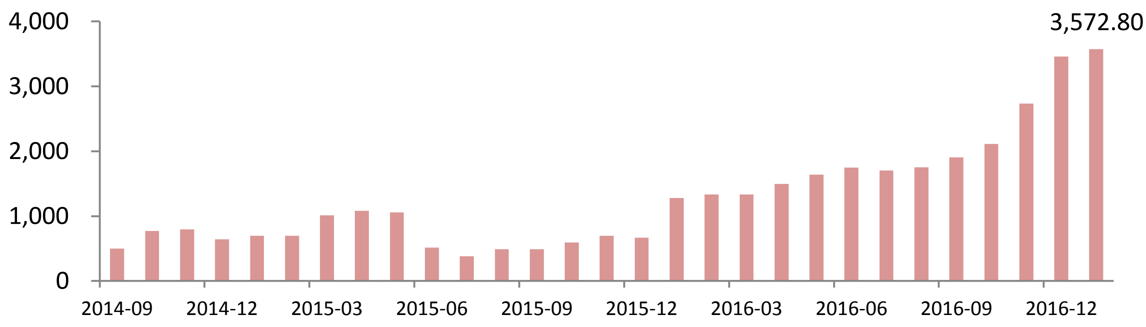
Exhibit 4: Leverage as characterized by rising Repo balance and volatility in Repo Rate



Source: Wind, ChinaAMC as of Feb 6, 2017

Coming to market merely two year ago, MLF has become the policy tool of choice when it comes to manage the monetary base. In 2016 alone, PBoC had deployed 2.79 Trillion RMB via MLF, and year end, its balance currently already stood at 3.57 Trillion.

Exhibit 5: MLF Balance reaching record high and became the policy tool of choice (RMB Billion)



Source: Wind, ChinaAMC as of Feb 6, 2017

Loomed by RMB depreciation, funds outstanding for foreign exchange suffered an outflow of 2.9 Trillion RMB in 2016. Using the Reserve Requirement Ratio (RRR), the central bank managed to lock up about 20 Trillion RMB in bank deposit. Most of the liquidity are provided, however, through MLF instead of RRR, which was cut only once in 1Q2016. Funding extended to commercial banks via MLF were equivalent of five 50 Bps RRR cuts.

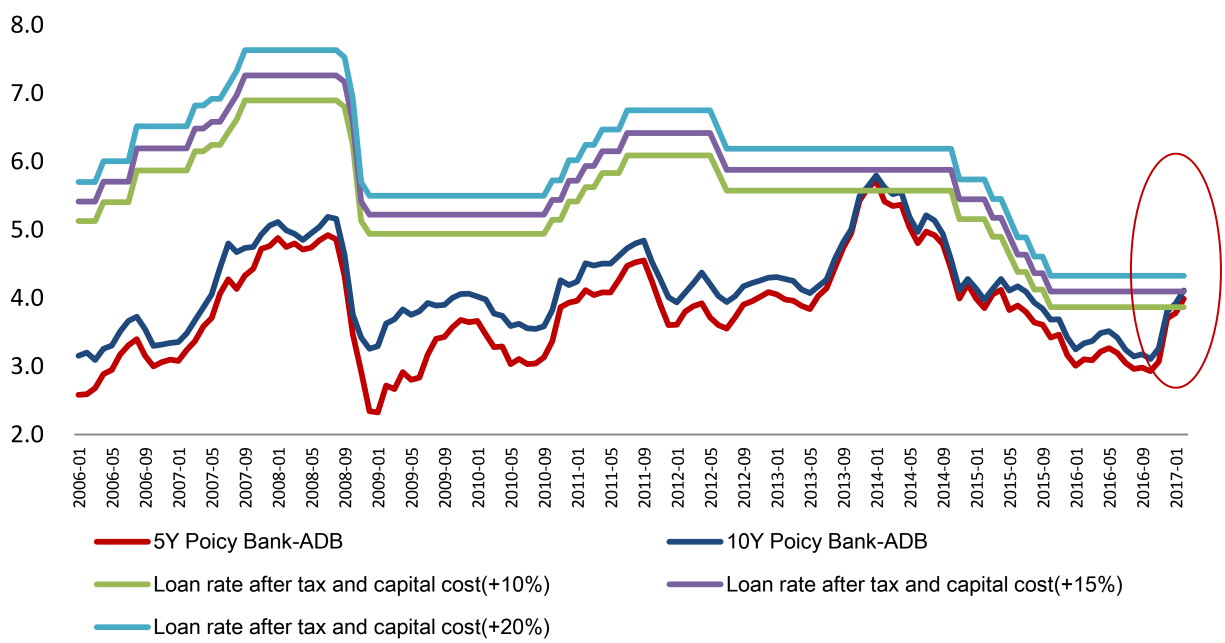
The key difference between MLF and RRR Cuts lies in prices. To commercial banks, to supplement liquidity using MLF comes with a much higher interest rate and has to be repaid eventually. Commercial banks hence have to manage liquidity much prudently than they otherwise would have with liquidity obtained from RRR cut, which is cheaper and has no maturity. To central banks, MLF comes in much handy as it avoids the market misconception usually implied by a non-discriminate RRR cut, especially in times when currency depreciation pressure mounts. Handed out in forms of auctions, the liquidity support was more precisely targeted . More importantly, using MLF, PBoC has been able to reveal its policy intention to push up market interest rate levels and deleverage.

Outlook

1. Current rate levels start to look attractive

The yield on rate bonds, such as the ones offered by Agricultural Development Bank (ADB) has shown good value from an asset allocation point of view. Comparing with the benchmark loan rate, after taking into account of taxes and cost of the bank's own capital, investing in rate bonds is at least equivalent to loan at benchmark rate +15%.

Exhibit 6: Current yield level v.s. Loan Rate

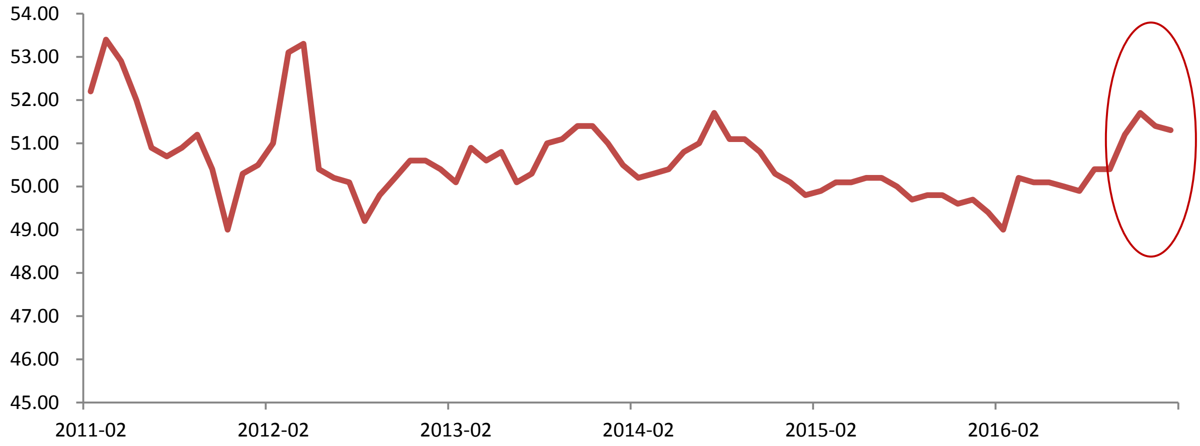


Source: Wind, ChinaAMC as of Feb 6, 2017

2. Monetary policy may become accommodating after de-risk and economy weakness

The current tapering moves are mainly targeted at de-leverage and de-risk. The domestic economy in the short term is still in the pulse rebound mode as evidenced by the recent uptick in PPI and CPI readings. The rebound began in the end of 2015 and similar mini cycles usually last for 18-24 months and has largely attributed to the supply side reform efforts and external recovery in commodity prices. Yet little has been promised for the rebound to extend into the second half of 2017 as suggested in the weakening PMI readings for Jan 2017.

Exhibit 7: Jan 2017 PMI reading fell 3 months in a row



Source: Wind, ChinaAMC as of Feb 6, 2017

Once the growth softening has been further confirmed, monetary policy will soon follow to become accommodative given that leverage risk has become less paramount.

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