

In Case You Missed It: CSOP's Weekly China Wrap Up

China's bond market under pressure from rumors, surging US dollar

China's USD 8 trillion bond market saw several days of turmoil last week, resulting in plummeting prices and year-high yields.¹

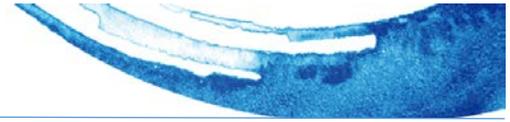
The market moves began Wednesday with a rumor that Guangxi-based brokerage Sealand Securities had lost contact with two key fixed income managers and that a huge loss was looming for the firm's bond portfolio. At the same time, brokerage house China Dragon Securities failed to settle an RMB 500 million interest rate swap, triggering a technical default.² Compounding matters, a money market fund operated by China's second largest fund house experienced heavy redemptions and an estimated loss of RMB 600 million.

As a result of the incidents, both the five-year and 10-year government bond futures traded limit-down within minutes of opening on Thursday morning. The limit-down trading marked the first of its kind in the history of China's bond market, spurring 10-year government bond yields to jump 12bp to 3.36%. As icing on the cake for the shaky market, the US Federal Reserve raised interest rates, evaporating already-scarce liquidity in the inter-bank market. To ease the liquidity crunch, China's central bank injected USD 68 billion on December 15th and 16th. Although the PBOC's intervention calmed jitters temporarily, fixed income investors remain anxious about the market's uncertain future and the longer-term impacts of the black-swan event.³

Central Economic Work Conference concludes, "stability" emerges as core focus

The Central Economic Work Conference wrapped up on December 16th, the annual closed-door gathering of top officials tasked with crafting economic priorities. Stability represented the primary theme of meeting, with special attention given to avoiding the market turbulence and asset bubbles that plagued China's economy in 2015 and 2016. The sprawling, multi-day conference covered an array of topics, with the below points serving as the primary conclusions.

1. **Currency:** Policy makers expect the RMB to trade in a wider range in 2017, implying more tolerance for two-way volatility.
2. **SOE Reform:** 2017 will mark a crucial year for SOE reforms, with private investment encouraged in strategic sectors like utilities, oil and gas, railway, commercial aviation, telecommunications, and military.⁴ SOEs are expected to improve incentive systems and increase competitiveness by accepting more private investments.
3. **Supply Side Reform:** Policy makers expect a continuation of progress in 2017. Of note, supply-side reform in China's agricultural sector was given its own category, signaling its importance. The sector's price mechanisms are expected to be the primary subject of reform.
4. **Monetary Policy:** Onlookers anticipate a "prudent and neutral" monetary policy in 2017, with focus shifting from economic stimulus to risk control and asset bubble deflation.
5. **Property:** The policy tone changed from "reducing inventory" for 2016 to "preventing asset bubbles" for 2017. President Xi pronounced that the property market's sole purpose should be providing accommodation, not speculation. Speakers also urged Tier 1 city governments to increase land supply and Tier 3 and 4 city governments to supply better public services (education and health care).
6. **Fiscal Policy:** A "proactive and efficient" fiscal policy was emphasized, indicating potential for a mildly expansionary policy and slight increase in the deficit.
7. **Corporate Efficiency:** Policy makers issued statements encouraging Chinese corporations to focus on innovation, quality, and branding. The declaration shows that the Chinese government is focused on increasing the quality of Chinese products to prepare for a future when low prices are no longer the country's main competitive advantage.



8. **Corporate Deleveraging:** Policy makers urged corporations to further deleverage in 2017 and to tap funding from equity markets to reduce bank borrowing.
9. **Pension Reform:** The Chinese government will push pension system reform in 2017 and is expected to announce relevant rules in the near term.

Depleting Treasury reserves to save the RMB, China cedes top US creditor spot to Japan

China surrendered the mantle of America's largest creditor this week, a result of the country's steady liquidation of US Treasuries to prop up the flagging RMB. Japan has instead assumed the top spot, boasting USD 1.13 trillion of reserves versus China's \$1.12 trillion. Japan had previously bested China just once in recent memory, when the country overtook China in for one month in February 2015. This week's role reversal is attributable to the surging dollar in the aftermath of Trump's election, which put additional pressure on an already-shaky RMB. While China has been tapping into the country's reserves to steady a volatile RMB, Japan has displayed more willingness to let its currency depreciate. The diverging attitudes have left China's reserves depleted by USD 41.3 billion in October compared to Japan's \$4.5 billion reduction.

Ultimately, although the financial impact of China's capitulation is minimal, the psychological ramifications could put Beijing on the defensive in the country's dealings with Washington. Dumping US debt to forcibly appreciate the Dollar is no longer a viable policy option, leaving Beijing in a slightly weakened position at the bargaining table.

China enmeshed in WTO argument upon the country's 15th anniversary of entry into the organization

Although December 11th marked China's 15th year as a member of the World Trade Organization, the anniversary was not a happy one. Whereas Chinese officials believe the occasion signifies conferment of automatic "market economy" status, the US and EU disagree.⁵ They believe China has not yet made the liberalization reforms necessary for bestowal of equal status and, as a result, can impose 7% and 5% anti-dumping duties on Chinese imports. In response to the disagreement, China launched a formal complaint against the United States and Europe at the WTO.

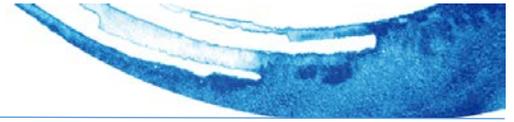
China strongly desires the status upgrade, as the new title would change the way export prices are calculated and render it more difficult to levy punitive tariffs on Chinese goods. Under WTO rules, countries without "market economy" status are subject to penalty if "market"-labeled economies believe the non-marketers are dumping products, or selling goods abroad at lower prices than they are sold domestically. For non-market economies, this penalty is calculated by comparing prices of similar goods sold in other 'surrogate' countries as a way to analyze dumping margins. China, however, attests that non-Chinese surrogate prices are not a fair point of comparison and should not be utilized.

The disagreement comes at an unfortunate time, with tensions already flaring between the US and China over Taiwan and South China Sea disagreements. Although both sides feel that their side is correct, legal opinion is mixed. As the WTO lacks a clear cut definition of "market economy," experts foresee the litigation process dragging out over several years.

US and foreign actors issue resistance to Trump's Taiwan provocations

Trump's attempts to use Taiwan as a bargaining tool in trade negotiations with China has received criticism from both US manufacturers and China's central government.

Despite supporting Trump in November's election, several prominent Rust Belt companies have expressed concern about ramifications from a potential trade war between the US and China. Among



them, companies that import raw materials from China and those who export to China would be disproportionately impacted.

Beijing concurrently expressed disappointment with Trump's remarks on Taiwan, with the country's state media comparing Trump to an "ignorant child" in matters of foreign policy. Although the President Elect's December 2nd call aimed to empower Taiwan, some onlookers expect Beijing to crackdown more heavily on Taiwanese affairs. Although tensions are not yet high enough to motivate a forceful crackdown, analysts do question Taiwan's ability to defend against military action, considering its weak economy and nearly-nonexistent domestic arms industry.

Notes:

1. USD: US Dollar, the national currency of the United States
2. RMB: Renminbi, the national currency of China
3. PBOC: People's Bank of China
4. SOE: State-owned enterprises
5. EU: European Union