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

Inclusion of onshore bonds in Bloomberg index represents major step in market opening

Momentum seems to be gathering behind inclusion of Chinese bonds in global indices, a policy change that could bring billions of dollars into China and help prop up a sluggish Yuan. Bloomberg announced the launch of two new onshore bond indices, bringing "world + China" and "emerging market + China" indices to market on March 1, 2017. [1] The products will include RMB-denominated, interbank-traded bonds issued by the Chinese government and policy banks.

As the second major index provider to include onshore China, Bloomberg's announcement is a show of confidence. Although China is the world's third largest bond market, the country's steadfast control of onshore markets has made international indices reluctant to include the bonds in major indices. Bloomberg's announcement will likely inspire rivals such as Citibank and JP Morgan to expedite their ongoing review processes and include RMB-denominated bonds in their respective World Government Bond Index and Global Emerging Bond Index.[2]

Although the Chinese currency may continue to depreciate in 2017, China's onshore bond market remains an attractive destination for long-term investments from foreign pension and sovereign fund managers. The market is less attractive for short-term speculators, however, as overseas investors remain unable to trade hedging tools such as interest rates and FX derivatives.

PBOC forbids payment companies from earning interest on client funds, threatening business models

The PBOC released rules forbidding third-party payment companies from earning interest on clients' money, regulation that will dramatically alter the business models of China's leading payment companies.[3] Services like Alibaba's Alipay and WeChat's Wallet are reeling from the policy announcement, which was imposed to prohibit customer funds from being used for speculative investment.

The announcement strikes at the heart of existing business models. As China's payment companies charge a very low transaction fee, interest on funds temporarily stored in client bank accounts represent the largest income source. Alipay exemplifies this model, charging merchants 0.6% of each transaction compared to PayPal's 2.9% plus 30 cents. China's leading payment companies are estimated to earn several million RMB per day on the approximately RMB 460 billion (USD 67 billion) stored in client accounts.[4] The new rules will upend this income stream, forcing companies to deposit client funds in non-interest-bearing, state-run accounts.

The regulations are anticipated to force smaller payers out of market, as they lack the bargaining power to switch from an interest-income to a fee-based model.

China's SOE watchdog deems debt risks as "controllable"

China's SOE watchdog labeled debt burdens at the country's central State Owned Enterprises (SOEs) as "controllable," anticipating continued deleveraging into 2017. China's 102 centralized SOEs saw debt-to-asset ratios fall 0.3% in 2016, the third decline in three years. The State-Owned Assets Supervision and

Administration Commission (SASAC) attributed the improving ratio to SOE's recovering profit margins, which grew 0.5% YoY. Disaggregating the results by sector, construction, transportation, and real estate saw the highest profitability YoY.[5] Petroleum, textiles, and tobacco saw a decrease in profit margins in 2016 though remained in the black, while the iron, chemicals, and non-ferrous metals sectors experienced losses on the year.

Accelerated deleveraging is anticipated in 2017 due to a State Council commitment to improving SOE competitiveness. SOE reform plans include introduction of market-oriented managerial incentive schemes as well as increased openness to private sector competitors.

In strong tightening signal, PBOC surprises markets with increase of medium-term lending rates

Surprising markets, the PBOC set Medium Term Lending Facility (MLF) rates 10 basis points higher than usual last Wednesday, the first rate hike since the policy mechanism was introduced in October 2014. The facility has increasingly become the PBOC's chosen lever for targeted credit delivery. As China's exports fall and central bank reserves decline, the MLF program enables policy makers to increase borrowing costs and signal tightening without contributing to depreciation pressure, as RRR cuts would.

The rate hike is the latest assertion in the PBOC's "prudent and neutral" monetary tightening ballet, as central bankers work gingerly to mop up excessive credit while maintaining sufficient liquidity. Last week's announcement saw 6-month and 1-year rates set at 2.95% and 3.10%, respectively. Although the increase was only 10 basis points, it nonetheless rattled bond markets. Benchmark 10-year treasury futures fell almost 1% while yields rose 2.4bps.

Nearly 3 billion trips anticipated for Chinese New Year holiday

China's onshore markets are shuttered this week as the populace fans out in celebration of Chinese New Year. Akin to Christmas in the Western world, 'Spring Festival' or *Chunyun* is China's most important holiday. In the world's largest human migration, inhabitants of China's populous coastal cities embark on extended trips to visit family and friends in smaller population centers.

Economic planners at the National Development and Reform Commission estimate nearly 3 billion trips will be taken in celebration of the holiday. The majority of the ventures—2.5 billion—will be overland, while the remainder of vacationers will travel by train, plane, and boat. In addition to ventures across mainland China, a growing number of inhabitants will head abroad for the holiday. Though the majority of overseas travelers remain in the Asia Pacific region—Japan, Singapore, and Thailand are especially popular destinations—bookings to Europe were up by 56% YoY. Travelers abroad are expected to spend over RMB 100 billion on ticket purchases and travel incidentals.

Notes:

1. Bloomberg's Global Aggregate + China Index combines the Global Aggregate Index with the treasury and policy bank component of the China Aggregate Index. The EM (Emerging Market) Local Currency Government + China Index combines the EM Local Currency Government Index and treasury component of the China Aggregate Index. Note that one cannot invest directly in an index
2. Citibank's World Government Bond Index (WGBI) measures the performance of fixed-rate, local currency, investment grade sovereign bonds. The JPMorgan Emerging Market Bond Index (EMBI) are a set of three bond indices that track bonds in emerging markets. Note that one cannot invest directly in an index
3. PBOC: People's Bank of China
4. RMB: Renminbi, the national currency of China
5. YoY: Year over year