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

China's rate curves reverse, signal faltering tightening policies

The yield of China's 5-year corporate bonds exceeded the Central Bank's 5-year benchmark for the first time in 9 years. This reversal implies it is cheaper for Chinese corporations to borrow from banks than to issue new bonds in the market.

What has driven the reversal?

In attempt to liberalize interest rates and spur economic growth, the People's Bank of China (PBOC) has spent the past nine years gradually reducing the benchmark rate. The benchmark rate provides a guideline to commercial banks, who are permitted to tweak lending rates based on the credit rating of their corporate borrowers.

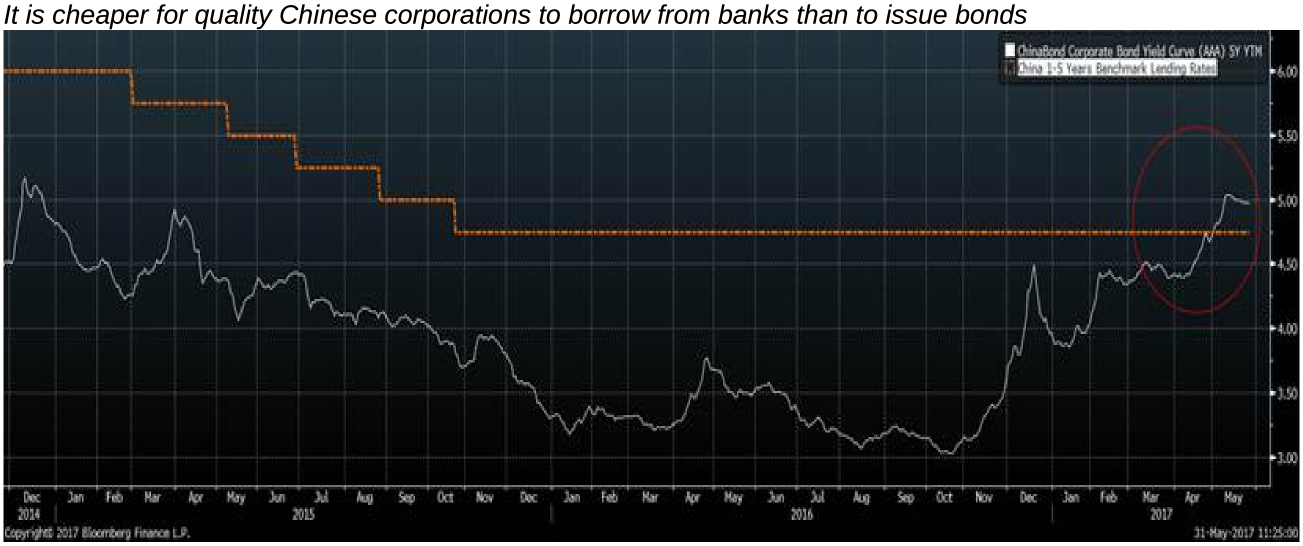
In addition to borrowing from banks, high quality corporations can issue bonds into the market. The free-floating, 5-year yield of locally-rated AAA corporate bonds has hovered several basis points below the benchmark rate for several years, offering an incentive for bond issuance.[1] However, this pattern began to change in December 2016. Market confidence fell precipitously in the aftermath of the Sealand Securities forgery scandal, spurring a sharp bond selloff and sending yields skyrocketing from 3% to 4.5%. The recent anticorruption drive and asset pool regulatory tightening have also combined to boost yields. As a result, the current 5% yield exceeds the benchmark lending rate of 4.75%.

A return to bank lending?

The high bond market yields may encourage quality Chinese companies to cease issuing bonds and instead return to bank lending. This behavior is a blow to regulators, whose financial disintermediation reforms were designed to encourage fund raising via capital markets and discourage bank lending. Because of these unintended consequences, some onlookers expect the central government will pause the aggressive regulatory tightening and instead focus attention on lowering bond yields.

ChinaBond Corporate Bond Yield Curve (AAA) 5Y Index.

It is cheaper for quality Chinese corporations to borrow from banks than to issue bonds



Orange line: People's Bank of China 5-year benchmark lending rate
White line: Yield of AAA rated corporate bonds
Source: Bloomberg, as of 6.2.2017. *Past performance is no guarantee of future results.*

The views expressed represent an assessment of market conditions at a specific point in time, are opinions only and should not be relied upon as investment advice regarding a particular investment or markets in general. Such information does not constitute a recommendation to buy or sell specific securities or investment vehicles.

Offshore RMB strengthens unexpectedly

The offshore Chinese Renminbi (CNH) appreciated more than 1% over the Chinese Dragon Boat Festival holiday, strengthening from 6.88 to 6.75 against the US Dollar.

What caused the dramatic move?

Several theories have emerged explaining the currency movement: an offshore overnight rate hike and modification of the Renminbi fixing algorithm.

<u>CNH Rate hike:</u>
As an immediate cause of the currency move, some market players blamed the expensive CNH overnight rate in Hong Kong, which surged to 42.8% on June 1, 2017 (Bloomberg ticker: HICNHON Index). This price hike caught short sellers off guard, as it significantly increased their cost of carry. The bears abandoned their positions en masse, buying back in at the popular cut-loss level of 6.78-6.80. The sudden buying spree fueled upward momentum, perpetuating the squeeze on the remaining short sellers. But why did the offshore overnight rate jump in the first place? Two explanations have been posited.

1. It is rumored that state-owned banks were actively absorbing CNH liquidity in the offshore market at the behest of the People's Bank of China. Some argue that China's monetary authorities sought to flex their muscle and scare off short sellers after Moody's May 24th downgrade.

2. In addition, the rate hike was at least partially caused by liquidity tightening in the onshore market. Analysts cite onshore incidents like the January 2016 equity market circuit breaker fracas and December 2016 rubber stamp fixed income scandal as precedent. Both events caused onshore liquidity tightening, which also fueled CNH rate hikes and collateral damage in the offshore market.

<u>Modification of the Renminbi fixing algorithm:</u>
Another theory fingers the PBOC as the main cause of the currency movement. The central bank unexpectedly set the reference rate for RMB up 0.8 percent.[2,3] Onlookers believe that the bank tweaked the model it used to determine the Renminbi fixing rate, specifically altering the how it measures the previous day's closing price. Before the modification, international hedge funds could manipulate the CNH closing price with aggressive end of day trading and establish positions accordingly. To prevent the practice, the PBOC developed a new formula that de-emphasized the weighing of previous closing price, making it more difficult to predict or manipulate the official fixing rate. Acknowledging that their strategy was obsolete, many hedge funds chose to close extant short positions, fueling the CNH appreciation.

CNH Overnight Rate (Ticker: HICHNON) Surges to 42.8%

Source: Bloomberg, as of 6.2.2017. *Past performance is no guarantee of future results.*

Premier Li meets European Union leaders, cements partnership in the wake of US withdrawal from Paris Agreement

China's Premier Li met European Union (EU) leaders in Brussels for an EU-China Summit. Roughly 400 participants attended the two-day gathering to pledge their joint commitment to free trade and climate change mitigation. Although a number of Memorandums of Understanding were signed, the two sides did not release a final communique due to lingering disagreement over several trade issues. Nonetheless, in an environment of rising populist protectionism, Trump's Paris Accord withdrawal, and growing uncertainty about the sanctity of NATO, signs indicate that the EU is gradually pivoting toward China and Asia.[4]

Key issues:

1. The Environment:
Leaders from both sides condemned Trump's decision to leave the Paris agreement and declared that progress on fighting climate change would continue "with or without" the United States. Participants committed to reducing fossil fuels, accelerating development of green technology, and providing financial assistance to help poorer countries cut emissions. They also reiterated agreements on energy policy, promising to share best practices on energy regulation, renewables, grid design, and nuclear policy.

2. Trade, Investment, and Market Access
Trade between the EU and China is robust, yet contentious. The EU is China's largest trading partner while China is the EU's second largest. However, disagreement remains about issues of cross border investment and market access. For example, Chinese investors spend 5 times more acquiring European companies than European companies spend acquiring companies in China. China's acquisition spree is fueled partly by the desire to upgrade the country's manufacturing capability by securing access to EU technological knowhow. Europe also cites a desire to acquire businesses in China to tap into the country's growing consumer class, but laments existing restrictions that render market access difficult. On this front, some peripheral progress was made in developing a framework for customs cooperation, intellectual property, and research and innovation.

3. Market Economy Status:
China has long wanted Europe to recognize the country as a "Market Economy" under the tenets of the World Trade Organization. Without that stamp of approval, China's goods are categorized as "significantly distorted" by state intervention and are subject to more anti-dumping duties than any other nation. Despite China's pleas, Europe is hesitant to upgrade China to market economy status. Worried that the influx of cheap steel and solar panels will hurt domestic manufacturers, the bloc asserts that it will not grant recognition until China abolishes barriers to foreign investment in China's market.

4. Steel*:*
Arguably the most contentious issue at the summit involves the global glut of steel. In a speech, European Commission President Jean-Claude Juncker asserted that China's steel overcapacity more than doubled total EU capacity. Seeking to reduce that overcapacity, China is lobbying hard to remove all anti-dumping tariffs on stainless steel, though Europe asserts that some protective tariffs should remain. Representatives from the summit said that both sides had moved closer to an agreement, but the positions remain separated.

5. One Belt, One Road
China was dismayed that President Xi's recent Belt and Road summit lacked top EU leadership. Some European leaders had expressed skepticism about the initiative, worrying that the projects lacked transparency and cooperation with participants like Russia would bode poorly. In Brussels, however, Europe relented somewhat. The two sides signed the *Memorandum of Understanding Aiming at Facilitating a Co-investment Framework by China's Silk Road Fund and the European Investment Fund and the establishment of the China-EU Joint Investment Fund,* committing both sides to develop a framework for pursuing investment opportunities in conjunction with other global institutions like the Asian Infrastructure Investment Bank, European Investment Bank, and European Bank for Reconstruction and Development.

6. Tourism:

Seeking to increase the flow of visitors from China to the EU, the participants signed an agreement to understand the needs of Chinese tourists, promote cross-border tourism investment, market lesser-known destinations, and improve air connectivity. The agreement will also streamline the EU-China visa facilitation process.

New rules curb irregular stock selling from major shareholders

The China Securities Regulatory Commission (CSRC) revised laws governing the sale of shares by listed company insiders, closing oft-exploited loopholes. The country's two major stock exchanges followed up with publication of detailed rules.

The problem: existing loopholes

The CSRC passed insider trading laws during the January 2016 circuit breaker turmoil to prohibit insiders from jettisoning shares into the falling market. The January 2016 rules defined insiders in three parts: as controlling shareholders, investors holding 5% or more of outstanding shares, and senior executives of listed companies. However, crafty executives and shareholders soon discovered ways to sidestep the requirements. As one example, the CSRC capped the number of shares that insiders can sell in the open market during auction periods. However, insiders realized they could avoid the rule by selling shares to third parties via block trading, allowing the outsider to unload the shares. Another evasive tactic involved executives resigning before selling shares and/or leveraging inside information to time their stake reduction.

The new rules:

The reforms imposed several restrictions:

1. Information disclosure: Major shareholders and management should report reduction plans 15 trading days in advance of transactions
2. Block trading: Stocks transferred through block trading should not surpass 2 percent of a company's total shares in 90 days
3. Selling of non-public offering shares: Those holding over 5% of a company cannot have non-public offering shares exceed 50% of total holdings within 12 months
4. Equity transfers: Transferees are not permitted resell shares within six months

Notes:

1. *S& P BOND RATING CATEGORIES: AAA: An obligation rated 'AAA' has the highest rating assigned by S&P Global Ratings. The obligor's capacity to meet its financial commitment on the obligation is extremely strong. AA: An obligation rated 'AA' differs from the highest-rated obligations only to a small degree. The obligor's capacity to meet its financial commitment on the obligation is very strong. A: Obligations rated A are judged to be upper-medium grade and are subject to low credit risk. BBB: An obligation rated 'BBB' exhibits adequate protection parameters. However, adverse economic conditions or changing circumstances are more likely to lead to a weakened capacity of the obligor to meet its financial commitment on the obligation. BB; B; CCC; CC; and C: Obligations rated 'BB', 'B', 'CCC', 'CC', and 'C' are regarded as having significant speculative characteristics. 'BB' indicates the least degree of speculation and 'C' the highest. While such obligations will likely have some quality and protective characteristics, these may be outweighed by large uncertainties or major exposures to adverse conditions. D: An obligation rated 'D' is in default or in breach of an imputed promise. For non-hybrid capital instruments, the 'D' rating category is used when payments on an obligation are not made on the date due, unless S&P Global Ratings believes that such payments will be made within five business days in the absence of a stated grace period or within the earlier of the stated grace period or 30 calendar days. The 'D' rating also will be used upon the filing of a bankruptcy petition or the taking of similar action and where default on an obligation is a virtual certainty, for example due to automatic stay provisions. An obligation's rating is lowered to 'D' if it is subject to a distressed exchange offer. NR: This indicates that no rating has been requested, or that there is insufficient information on which to base a rating, or that S&P Global Ratings does not rate a particular obligation as a matter of policy.*
2. PBOC: People's Bank of China, the central bank of China
3. RMB: Renminbi, the official currency of China
4. NATO: North Atlantic Treaty Organization