HKEx 香港交易所

Inside Fixed Income and Currency (FIC) Monthly Newsletter

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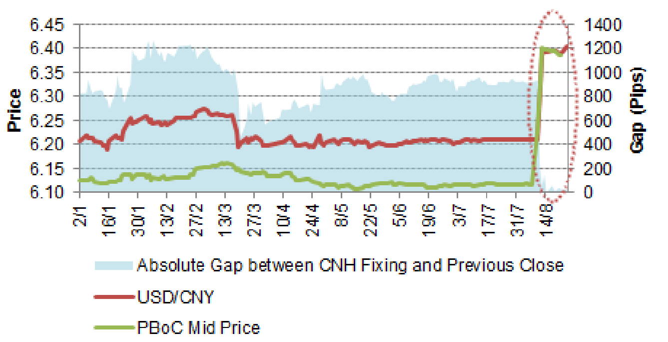
Monthly Highlights

- **On 11 August, the People's Bank of China (PBOC) introduced a new daily fixing mechanism for USD/CNY exchange rate, resulting in the onshore RMB reference rate weakening by 1.9 per cent.**
- **This might kick-start a "new normal" for the RMB, one that is more flexible and market-driven.**
- **HKEx's USD/CNH futures market continued to provide the best liquidity and strong market depth in periods of unexpected USD/CNH volatility**
  - **All-time monthly turnover of 42,412 contracts (US$4.241bn notional) in August 2015**
  - **All-time daily turnover of 8,061 contracts (US$806mn notional) on 12 August 2015 and all-time after-hours daily turnover of 1,080 contracts (US$108mn notional) on 24 August 2015**
- **Open interest increased sharply to 13,620 contracts (US$1.3bn notional) as of end of August, up 25 per cent compared to end of last month**
- **Demand remains in offshore RMB fixed income products, including deposits, although investors may demand a higher return**
- **In the course of further opening up of the Chinese domestic financial and capital markets, it is expected that more debt defaults could occur**
- **Investors can use HKEx's USD/CNH Futures, both as a cost-efficient risk management tool to hedge against RMB price risk, and to capitalise on short term trading opportunities**

Absolute Gap between CNY Fixing and Previous Trading Day Close Dropped Substantially



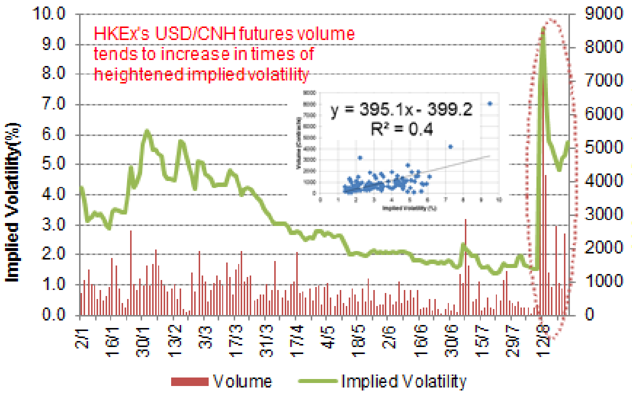
USD/CNY has traded back and forth within a tight band of 6.18 to 6.28 since January. However, at 9:15 am on 11 August, the People's Bank of China allowed the RMB to depreciate almost 2 per cent against the US dollar to levels last seen three years ago, sending a shock through currency markets.

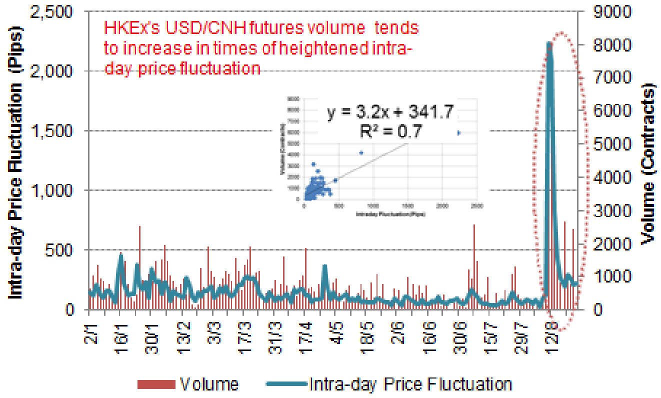
PBoC's new daily fixing framework is based on the previous day's closing rate in conjunction with supply/demand factors and movements in other currencies, which is more market driven. The absolute gap between RMB fixing and the previous trading day close has dropped substantially from around 900 pips to 27 pips following the PBoC's move.

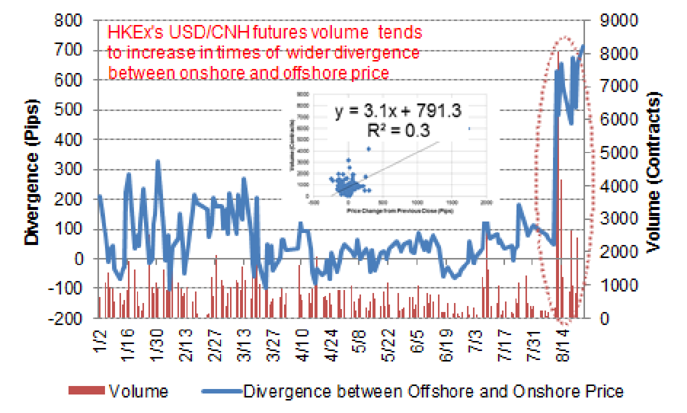
Since the move, the RMB in the offshore market has depreciated by more than 6 per cent and the trading volume of HKEx's USD/CNH futures contracts hit a yearly high of 5,816 contracts (US$581.6 million notional) on 11 August 2015 and then hit an all-time high of 8,061 contracts (US$806.1 million notional) on 12 August 2015. In the days after, HKEx's USD/CNH futures market continued to provide the best liquidity and strong market depth.

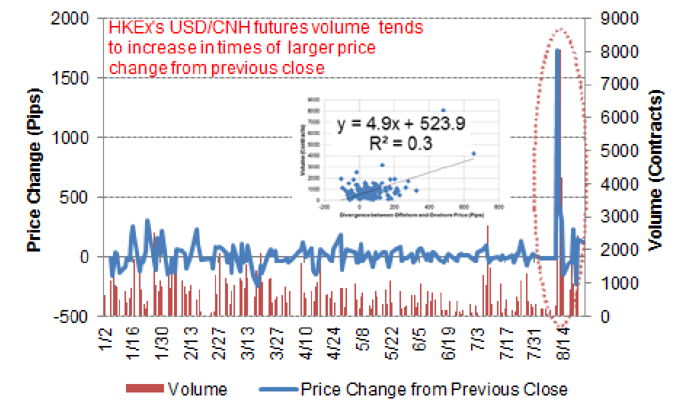
The trading volume of HKEx's USD/CNH futures has been a response to a number of driving factors, including OTC USD/CNH options implied volatility, intra-day price fluctuation, divergence between onshore and offshore price, and the price change from the previous close.

First, the 1-month implied volatility of OTC USD/CNH options has been trending downwards since the beginning of the year from









6.1 per cent to 1.5 per cent. However, responding to the PBoC action on 11 August, it has rebounded sharply from 1.5 per cent back to more than 5 per cent. As the implied volatility reflects the market expectation of potential price movements in the future, the positive correlation between HKEx's USD/CNH Futures' trading volume and implied volatility provides evidences that investors tend to use the contracts to hedge against the medium to longer term RMB price risk in the future.

Secondl following the PBoC move on 11 August, the average level of intra-day price fluctuations in the USD/CNH has jumped from 250 pips to more than 600 pips. The positive correlation between HKEx's USD/CNH Futures' trading volume and intra-day price fluctuation shows that investors might use the contracts to capitalise ultra short term trading opportunities.

Third, the divergence between the onshore and offshore RMB price has widened significantly from less than 200 pips to more than 500 pips, which provides arbitrage opportunities for investors to capitalise on the differences between the onshore and offshore price. The positive correlation between HKEx's USD/CNH Futures' trading volume and the divergence between the onshore and offshore RMB price demonstrates that investors could use the contracts to capitalise on the arbitrage opportunities from RMB price differences in different markets.

Finally, the USD/CNH price change from previous close has become more volatile recently following the PBoC actions. The positive correlation between HKEx's USD/CNH Futures' trading volume and the price change from the previous close shows that investors could use the contracts to manage exposure to the underlying market, or to capitalise on trading opportunities on a daily basis.

In summary, investors can use HKEx's USD/CNH Futures based upon their trading preferences and investment objectives, either as a cost-efficient risk management tool to hedge against RMB price risk, to capitalise on short term trading opportunities, or to exploit pricing discrepancies across the offshore and onshore markets.

Market Focus of the Month

Contributed by Frances Cheung, Head of Rates Strategy, Asia ex-Japan at Societe Generale

FX Impact on RMB Rates

CNY rates had been edging up since early July, and continued with its mild uptrend after the CNY fix regime change. The tighter CNY liquidity in onshore China has likely resulted from FX intervention and outflows. With the CNY fix mechanism mostly determined by market forces, FX intervention is left as the major tool to guide the market level of the CNY. We would see higher volatility in front-end CNY rates as the liquidity situation will be impacted as a result. How big and to which direction the impact on CNY liquidity will be depends on evolving market sentiment towards the CNY and how the PBoC would like to smooth its movement.

The CNY has stabilised after the initial depreciation, but against the backdrop of weaker EM currencies, worries over China's slowdown, and capital outflows from China in the past year, the bias should be for the CNY to weaken further. As such, potential FX intervention is likely to tighten onshore CNY liquidity further. That said, the PBoC has various tools, namely OMOs and RRR, to offset the (expected) liquidity withdrawal arising from the FX side. And it did deploy some to inject liquidity already. We believe the PBoC would like to see the benchmark 7-day repo and front-end rates to be capped at the 2.5 per cent handle, given the overall policy direction to support the economy. The PBoC needs to step up its open market operations, and may need to cut RRR further – we expect another 50bp RRR cut by year-end. OMO injection generally provides short-term money, whereas the impact from RRR cuts is of much longer-term.

Upward bias to CNY rates may also come from the possibility that investors could demand higher returns on CNY fixed income products given the higher volatility in the currencies. There is as such reduced optimism towards potential foreign inflows. But this should be a minor factor for onshore CNY rates given low foreign participation in the onshore bond market. The liquidity situation and monetary policy stance remain the key.

Offshore RMB rates have been fluctuating more than onshore rates upon the new CNY fix mechanism. CNH CCS is driven by the varying expression of FX view in spot versus forward outright. CNH CCS was paid up on the day the CNY fix mechanism changed when bearishness towards the CNY was expressed from spot to forward outright. CNH CCS then collapsed the next day as most bearishness was reflected in spot already. Afterwards, CNH CCS edged higher with spot stabilising and investors expressing views in forward outright again.

It is difficult to pin down how investors would like to position themselves in the respective FX markets at this stage. But beyond short-term fluctuations, we remain of the view that the recent relaxation of accessibility into the onshore repo market, together with increasing cross-border RMB flows, should lead to more sustainable convergence between offshore and onshore RMB rates. But we do note that by looking at CNH CCS – CNY IRS spreads, we are not comparing apples to apples. Ideally, we compare offshore-onshore interest swap rates, and interbank rates.

CNH interbank rates shot up, in line with the initial reaction in CNH CCS. However, CNH interbank rates eased back only slightly, did not follow the collapse in CNH CCS which was mainly FX driven not reflecting cost and return. This precisely illustrates the different nature of the two CNH rates. Any upward move in RMB deposit rates, on the other hand, could be slow. First, bearishness towards the RMB may not be huge enough for depositors to liquidate their RMB time deposits, which constitute more than 80 per cent of the RMB deposits in Hong Kong. Second, accessibility into the onshore market is still not entirely free. Demand remains in offshore RMB fixed income products, including deposits, although investors may demand a higher return.

Frances Cheung has 15 years of experience in providing investment and economic research, as well as offering advice. Before joining Societe Generale Corporate & Investment Banking (CIB), Cheung was Head of Asian Rates Strategy at Credit Agricole CIB. Prior to that she worked at Standard Chartered Bank, Primasia Securities (Asia) Limited and the Hong Kong SAR Government. Cheung was named Best Interest Rate Research Analyst in the Asiamoney Fixed Income Poll 2012, 2013 and 2014, and Best Local Currency Analyst in FinanceAsia's Fixed Income Research Poll 2012 and 2013.

Expert Corner

Contributed by Philip Li, Managing Director, China Chengxin (Asia Pacific) Credit Rating Company Limited

Two Frequently Asked Questions on the Chinese Domestic Debt Market

The recent crash of the Chinese stock market and devaluation of the RMB have not deterred international investors' interest in looking into the domestic RMB debt market. International investors are encouraged by the announcement of the Chinese central bank in July to lift the investment limits on debt securities for foreign central banks, multi-lateral organisations, and sovereign wealth funds to buy and sell debt securities in the inter-bank market, the largest debt market place which accounts for about 95 per cent of China's total debt issues as compared with the two stock exchanges.

The Chinese domestic debt market has been growing fast over the past decade. The majority of the debt issuers are Chinese state-owned enterprises, banks and corporations, along with some subsidiaries of foreign companies and a handful of multi-lateral organisations.

Two frequently asked questions by international investors are why are the credit ratings on the Chinese domestic debt issues so high, and why has been there so few debt defaults compared to loan defaults?

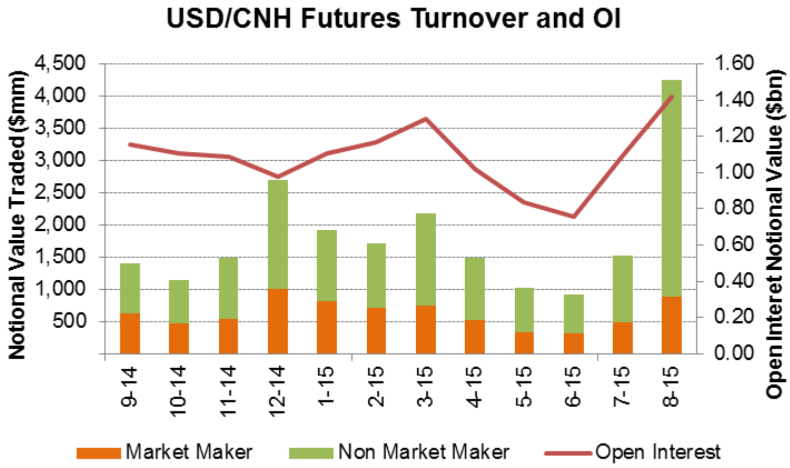
China is an emerging economy. It has a tailor-made method to develop its debt market. A domestic scale for credit rating is therefore deemed necessary as a majority of the debt issues would be rated "junk" on an international scale set by the three century-old international credit rating agencies. The China Insurance Regulatory Commission set the investment guideline/rule that insurance companies may only invest in a debt security which satisfies a minimum credit rating of AA as rated by one or more recognizsd domestic credit rating agency. Hence, debt issues which could be successfully launched into the market are all AA or above rated. Since 2012, three Chinese credit rating agencies, China Chengxin, Pengyuan and Dagong, have established their licensed offices in Hong Kong (Dagong also has one in Italy) to extend their business into the international market. Besides having to compete for clients with the three dominant international credit rating agencies, the other challenge to the Chinese credit rating agencies is how to explain to their local clients the gap between the lower international ratings to be assigned to them and the much higher domestic ratings they are accustomed to receiving in their home market. It is a matter of fact that such a rating gap applies to issuers in other emerging economies as well, not just China. So far, it has been difficult to find a common rule in doing mapping between the domestic and international ratings for the same Chinese issuer.

It was not until March 2014, when the Chinese debt market recorded its first public debt default case -- the "Chaori 11 debt" failed to pay interest on time. While there was a remarkable number of loan defaults recorded before the "Chaori 11 debt" default, the number of public debt defaults has been minimal on surface. In reality, possible public debt defaults before the "Chaori 11 debt" had all been bailed out directly or indirectly by the government. Why should the government extend its saving hands to those failing debt issues? A public debt issue default affects the investing public directly or indirectly, an ordinance for the protection of investors has yet to be perfected, and the majority of the debts are issued by state-owned enterprises and banks. These are the three main arguments for the government's rescue. In the course of further opening up the Chinese domestic financial and capital markets, it is expected that more debt defaults will occur.

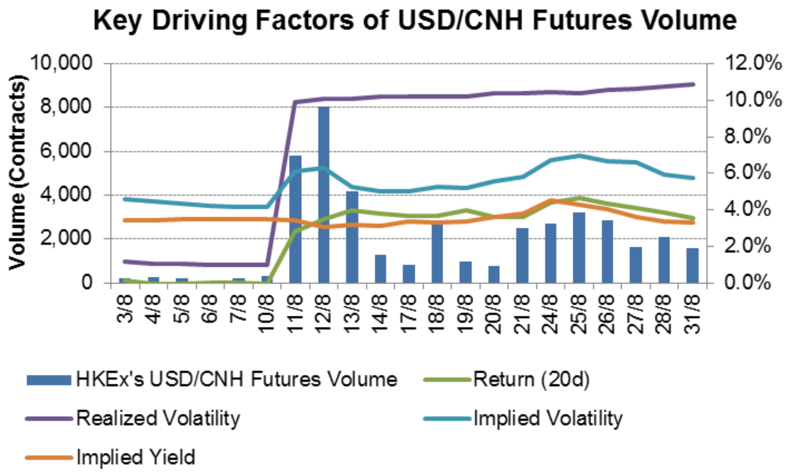
Mr. Philip Li is Managing Director of China Chengxin (Asia Pacific) Credit Rating Company Limited, Financial Columnist with Money Times (a weekly publication by Hong Kong Economic Times), Associate Member of the Central Policy Unit, Director of Asia Pacific Structure Finance Association.

Prior to his current post, he was Senior Vice President (Finance) of The Hong Kong Mortgage Corporation Limited and Executive Director and Head of Global Capital Markets with a renowned international bank. Li also served as Chairman of the Hong Kong Capital Markets Association, Member of the Hong Kong Stock Exchange Debt Listing Reform Working Group, Member of the Trade Development Council Financial Advisory Committee, Member of the Debt Reform Working Group under the Financial Service and the Treasury Department.

HKEx's USD/CNH Futures Market Statistics

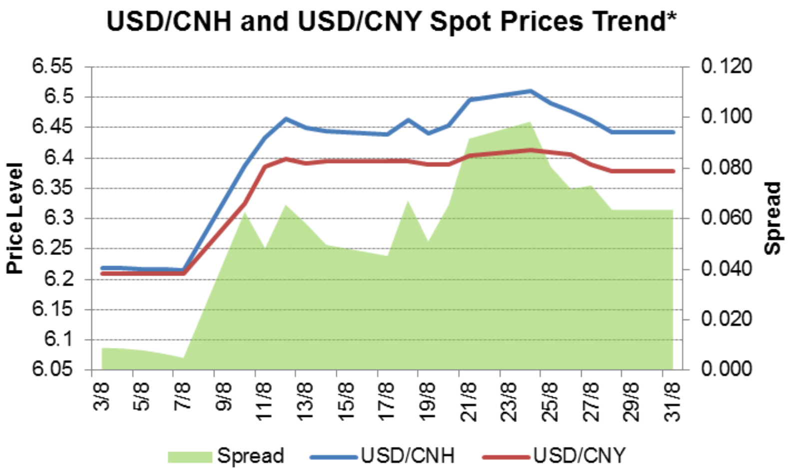


- In August 2015, a total of USD 4,241 million in contract value was traded, with an average daily notional value of USD 202 million.
- Non Market Makers contributed 79 per cent of contract volume, increased from 67 per cent in July 2015.



The following have been identified as the key driving factors behind the CNH futures volume:

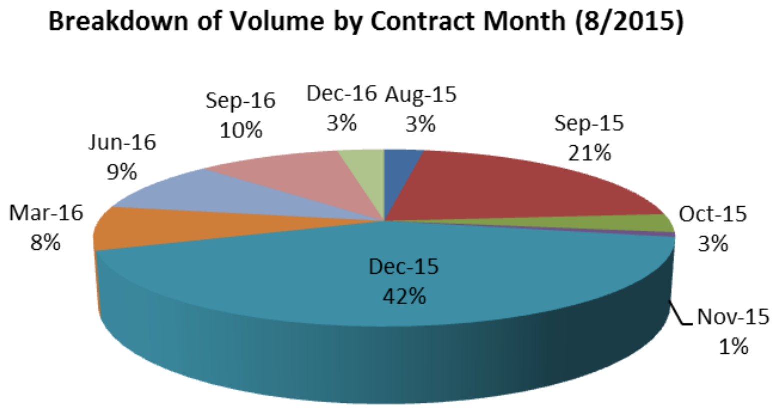
- Cumulative return of CNH/USD
- Realised volatility (20d)
- Implied volatility (USD/CNH 1Y ATM Implied Volatility from Bloomberg)
- 12 month forward implied yield



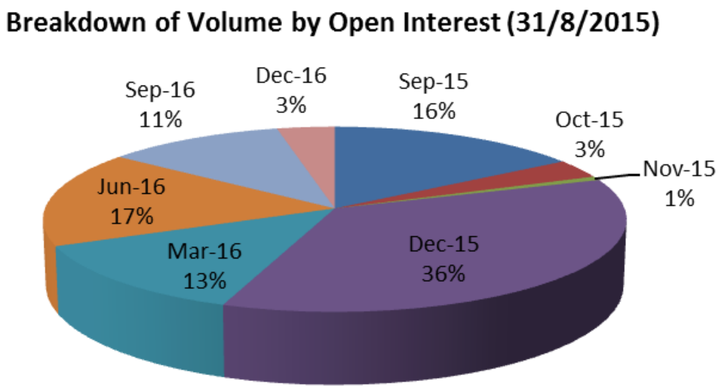
*Bloomberg closing price

- The spread between the USD/CNH and the USD/CNY widened throughout the month at around 200 pips. The CNH was trading at a discount to the CNY against the USD.

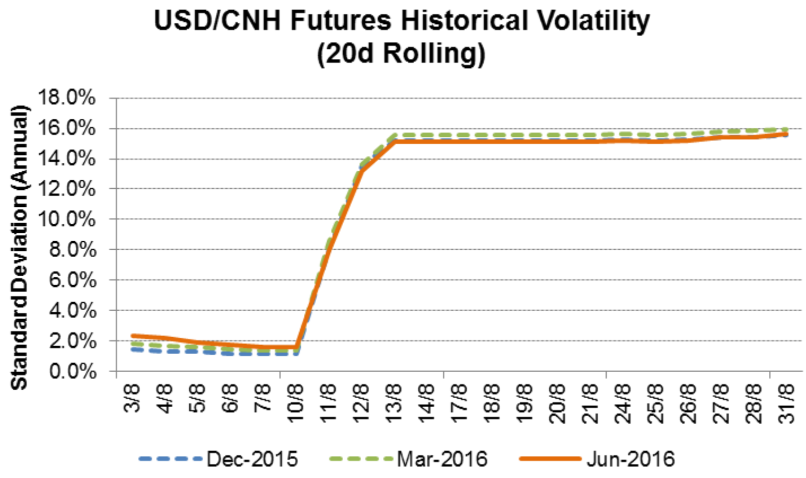
HKEx's USD/CNH Futures Market Statistics



- Trading volume was highest in the December 2015 contract.

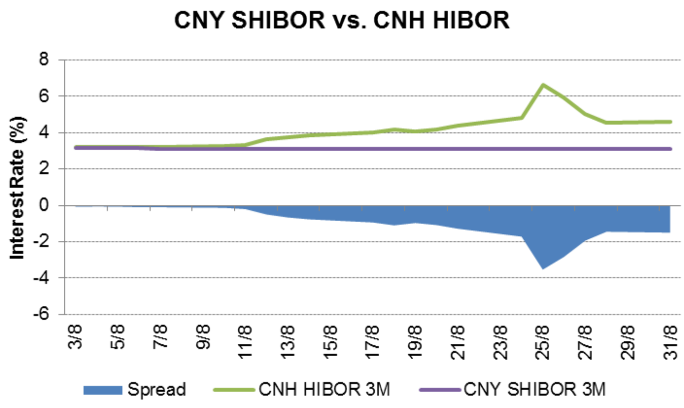


- Open interest was high in the September 2015, December 2015 and June 2016 contracts, which accounted for 69 cent of total open interest at the end of August.

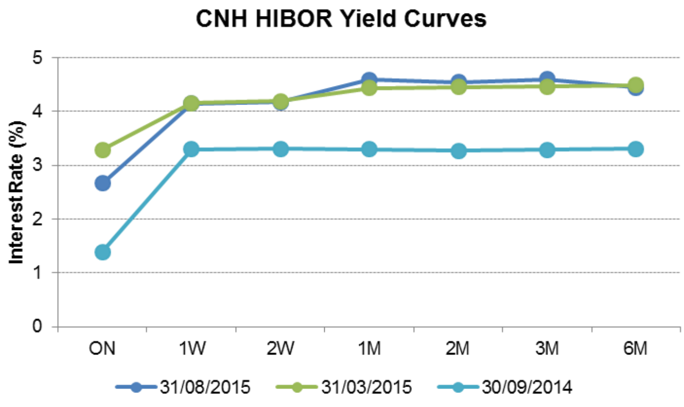


- Volatility in USD/CNH Futures ranged between 2 to 16 per cent in August 2015.
- The volatility spreads across far month contracts and front month contracts was similar towards the end of August 2015.

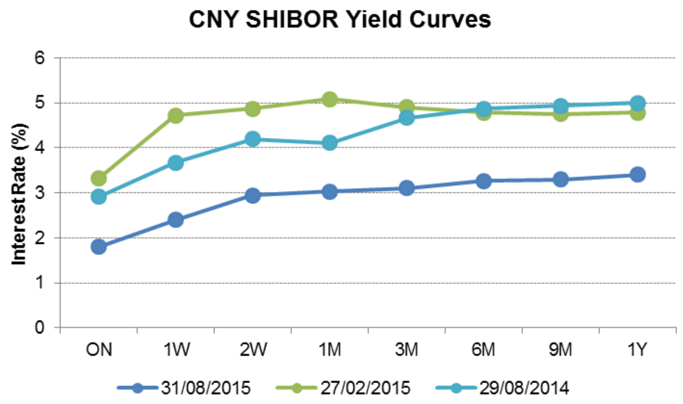
RMB FIC Market Review - Short-Term Interest Rates and Fixed Income



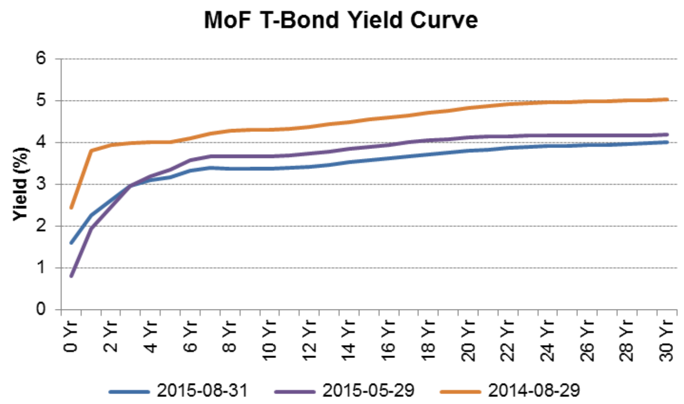
Onshore rates (CNY SHIBOR) diverged from the offshore rates (CNH HIBOR) and the spread between them widened throughout the month.



The CNH HIBOR yield curve in August 2015 steepened in the short end and remained relatively stable in the long end, a comparable shape as the yield curve in September 2014.



The CNY SHIBOR yield curve in August 2015 steepened in the short end and sloped gradually upwards towards the long end.



The MoF T-Bond yield curve was gradually moving up. Compared to the short end of the yield curve, the long end dropped more during that period.

For more information about the USD/CNH Futures,

please visit: http://www.hkex.com.hk/rmbcurrencyfutures

If you have any question , please contact us at:

Address: 10/F One International Finance Centre

1 Harbour View Street, Central, Hong Kong

Email: FICD@hkex.com.hk