CCXI & CCXAP – Research & Commentary

Yield of 10-year Government Bonds Likely to Reach Its Peak to 3.5% in Q3

Hong Kong, 19 January 2021 -- The Research Institute of China Chengxin International Credit Rating Co., Ltd. ("CCXI Research Institute") released a report titled "Monetary Policy is from Broad to Stable and the Issuance of Interest Bonds Increased Significantly，the Yield might Gradually Reach the Peak to 3.5% in the Third Quarter: Review and Outlook of Interest Bonds of Year 2020", believing that with further economic recovery, micro policies are likely to tighten marginally as fundamentals become better, scale policy instruments may exit successively, and the supply pressure of interest bonds in 2021 will be probably lower than that in 2020; however, with the economy still recovering and unable to grow on its own yet, it's unlikely to see sharp changes in policies and the monetary policy is expected to maintain prudent on the whole.

According to the report, since there is room for structural adjustment under the objectives of controlling money supply and reducing cost, one targeted RRR cut is expected in the year. **In terms of yield, after taking into full account economic fundamentals, monetary policy, overseas environment and historical period, the report believes that the yield of 10-year government bonds is likely to reach its peak in the third quarter, reaching 3.4%-3.5%.**

According to the report, the monetary policy and the operation of the interest bond market in 2020 demonstrated three major characteristics. First, the monetary policy changed from an "easing" one to a "prudent" one and attached more importance to maintaining a moderate money supply and precise orientation. In early 2020, to address the impact of the pandemic, the central bank made several cuts to RRR and interest rates and increased credit supply to maintain reasonably sufficient liquidity. As the pandemic was contained at home and the macro economy improved marginally, the monetary policy gradually returned to normal, changing from an "easing" monetary policy to a "prudent" one, and under the prudent one, it attached more importance to maintain a moderate money supply and precise orientation. In 2020, liquidity changed from easing to tight marginally, but it remained reasonably sufficient on the whole, and the money market rate first dropped and then rose. **Second, affected by the countercyclical policy, increase in the issue volume of government bonds and local government bonds drove up the issue volume of interest bonds substantially.** The "three arrows" of proactive fiscal policies were introduced in all aspects. As a result, the RMB1 trillion special government bonds in support of the fight against the pandemic and the newly increased RMB3.75 trillion special bonds drove the issue volume of interest bonds to rise significantly by 51.95% year on year to RMB18.77 trillion, of which the issue volume of government bonds (including RMB1 trillion special government bonds) increased by 70.92% to RMB7.12 trillion, that of local government bonds went up by 47.71% year on year to RMB6.44 trillion, and that of policy financial bonds grew by 36.13% year on year to RMB5.21 trillion. **Third, the yield of 10-year government bonds witnessed a V-shaped movement and fell slightly at the end of the year.** In early 2020, against the backdrop of an easing monetary policy, the yield went downward on the whole; later, affected by a number of factors, such as economic recovery, a gradually normalized monetary policy and the outbreak of credit risk incidents in the first half of November, the yield continued to go up; at the end of the year, as the central bank increased net capital supply and interbank liquidity was eased marginally, the yield fell slightly.

Looking into 2021, CCXI Research Institute believes that the monetary policy will remain prudent, and there may be one structural RRR cut. In 2021, as the economy gradually recovers, the monetary policy is likely to be tightened marginally. However, as the economy is still recovering and is unable to grow on its own yet, the report suggests not making significant changes in the monetary policy and keeping it prudent. Controlling economic aggregate, stabilizing leverage, reducing cost and preventing risks are likely to be the policy directions in the next phase. In the selection of monetary policy instruments, the report says that the central bank has "stability-maintaining" operation room to maintain a moderate money supply and balance volume and price. While flexibly conducting reverse repo in the open market, it may reduce financing cost by guiding LPR, adopting targeted measures to reduce the interest rates of loans to private enterprises and small and micro enterprises, etc. and there is possibility of a targeted RRR cut. Due to factors like maturity of MLF, concentrated issuance of local government bonds and traditional tax payment, the liquidity pressure before the Spring Festival is small on the whole, and the central bank is likely to adopt reverse repo, MLF and other temporary liquidity arrangements to maintain stable monetary supply around the Spring Festival. In the meantime, given that the MLF stock is already at a high level and the continuation pressure upon maturity in the second half of 2021 will increase significantly, the central bank will probably make a targeted RRR cut in the third or fourth quarter when liquidity is under greater pressure.

In the meantime, the report points out that as the macro economy continues to recover, scale macro policy instruments will gradually exit, and the fiscal deficit ratio for 2021 is expected to fall to around 3%. It's very likely that special government bonds will no longer be issued, newly increased special bonds will fall slightly due to risk prevention needs, and the supply pressure of interest bonds is likely to be lower than that in 2020 but exceed RMB1.8 trillion. Specifically, the issue volume of government bonds is expected to reach RMB6.4 trillion, with a net financing amount of RMB2.3 trillion; the estimated issue volume of policy financial bonds is RMB5.2 trillion, with a net financing amount of amount RMB2.1 trillion. The issue volume of local government bonds is expected to approach RMB7 trillion, and zero or few bonds for debt replacement are expected to be issued. Under the maturity pressure of local government bonds, the issue volume of refinancing bonds will probably increase significantly to RMB2.4 trillion. When local governments' need to repay outstanding debts is considered, the issue volume of refinancing bonds is likely to expand further and reach nearly RMB3 trillion throughout 2021. The quota for new bonds may fall slightly to RMB4.2 trillion, of which the quotas for new general bonds and near special bonds are RMB1 trillion and RMB3.2 trillion respectively. After the retained quota for special bonds in support of small and medium-sized banks in 2020 is taken into account, the issue volume of new bonds is expected to reach RMB4.35 trillion in 2021.

The report forecasts that after factors such as economic fundamentals and liquidity disturbance are taken into full account, the yield of 10-year government bonds is likely to peak in the third quarter to reach 3.4%-3.5%. In 2021, it's very likely that vaccines will become widely available, the probability that the domestic economy will be worse than expected is small, and the world economy is expected to recover as a whole. The improvement of risk appetite may have certain disturbance on safe haven assets. In addition to factors like liquidity disturbance and release of credit risk in the bond market, the yield is unlike to decline but gradually rise to its peak. However, given that there are still uncertainties about the economic operation, the pace of recovery is likely to slow down marginally in the next half of the year, and the yield to fall from the top. The movement of the yield throughout the year can be roughly divided into three stages: slightly falling, going up on the whole and fluctuating within a range, and it is expected to hit its lowest point in the year around the Spring Festival. Against the backdrop of continuous economic recovery and the central bank's protection of liquidity around the Spring Festival, there is room for decline of the yield. However, under the prudent monetary policy, the probability that the yield will decline to 3% is small, and its lowest point is likely to be around 3.0-3.1%. In the third quarter, the yield is expected to gradually rise to its peak. Based on the law of the yield in the last few rounds that its growth has gradually shrank and the requirement raised by the central bank in its monetary policy report last year that "the yield curve of government bonds should facilitate interest rate fluctuations centering on medium-term lending", the peak of the yield of government bonds in this round may be around 3.4%-3.5%, and the fluctuation range of the yield in 2021, around 40-50 bps.

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