CCXI & CCXAP – Research & Commentary

Yield of 10-year China Government Bond May Fluctuate with a Low of About 2.7% in 2022

Hong Kong, 12 January 2022 --The Research Institute of China Chengxin International Credit Rating Co., Ltd. has recently issued a report entitled "Monetary Policy Eased Marginally in Maintaining Stable Growth， the Yield might Move around a Lower Level and the Inflection Point might Appeared in the Middle of the Year——Review and Outlook of Interest Bonds of Year 2021". The report opines that as the economy still face a downward pressure in 2022, policies may step up efforts to stabilize growth. The monetary policy will play both aggregate and structural functions, and the proactive fiscal policy is expected to remain strong. The pressure on interest rate bond supply may be higher than in 2021. Against this background, **the yield of 10-year China Government Bond may move lower to touch a bottom of around 2.7% amid fluctuations. With macro policies working gradually to stabilize growth, economic recovery may improve marginally in the second half of 2022, coupled with a high probability of the Federal Reserve's rate hike in mid-year or so. Thus the yield is expected to move higher before a turning point emerges in mid-year.**

The report summarizes three characteristics of monetary policy and interest rate bond market operations in 2021. First, the prudent monetary policy was more effective and precise with policy operations easing marginally in the fourth quarter. The first half of 2021 witnessed a monetary policy normalization. January and February remained in a transition from "easy" to "prudent" monetary policy that started in the second half of 2021. PBOC marginally tightened its operations and started to establish an operation market operation (OMO) mechanism for injecting a fixed amount of liquidity to the banking system in March. Stability was the theme of policy operations. In the second half of the year, PBOC strengthened OMOs amid gradually rising downward economic pressure and a growing number of liquidity disturbance factors. Policy operations were relaxed marginally, with the RRR cut twice across the board, the relending rate for agriculture and small businesses lowered and one-year LPR reduced. **Second, the issuance of interest rate bonds increased year-on-year, with local bond issuance expanding significantly under the pressure of debt rollover.** Interest rate bonds increased by 5.72% year-on-year to RMB19.84 trillion in 2021, with net financing down 15.13% year-on-year to RMB9.30 trillion. Specifically, China Government Bond (CGB) issuance fell by 4.50% year-on-year to RMB6.80 trillion, the issuance of policy bank bonds increased by 6.82% year-on-year to RMB5.56 trillion and the issuance of local government bonds rose by 16.12% year-one-year to RMB7.48 trillion. Under the rollover pressure from maturing local government bonds, the issuance of refinancing local government bonds expanded significantly. **Third, the yield of 10-year China Government Bond roughly showed an M-shaped curve, back to a downtrend in the fourth quarter.** The yield staged a bumpy upturn amid tightening liquidity and rising commodity prices early in 2021. Later the yield went lower with fluctuations amid slow issuance of local government bonds, stronger allocations from institutional investors and PBOC's RRR cut. The economy remained weak in the fourth quarter, promoting PBOC to announce a second broad RRR cut. The yield turned down again after a brief mild rise.

Looking forward to the policy trend in 2022, the report believes that monetary policy will remain stable and there is still a possibility of a broad RRR cut. Economic growth may face downward pressure in 2022. Under the background of PBOC's emphasis on "stepping up cross-cyclical adjustments, coupled with counter-cyclical adjustments" and "boosting the resilience of economic development and stabilizing the macro-economic climate", the monetary policy will keep putting stability front and center stable and remain flexible and well calibrated, give full play to both the aggregate and structural functions of monetary policy tools and beef up financial support for key areas in a well-targeted manner. In selecting monetary policy tools, the report holds that PBOC will attach greater importance to the precision and effectiveness of policy operations and may step up the use of structural monetary policy tools while flexibly conducting open market operations. In the first half of 2022, against the backdrop of a weakening economy, a need to improve the financing environment and relatively few external disturbance factors, the monetary policy is expected to have bigger elbow room with a chance of further RRR cut. Considering the lower RRR of some small financial institutions and the limited space for targeted RRR cut, one broad RRR cut is expected in the year.

In addition, the report notes that the proactive fiscal policy is likely to remain strong amid increasing downward pressure on the economy and marginally growing demand for steady growth. This background, together with further expansion in the size of maturing interest rate bonds, 2022 may see increasing pressure of interest rate bond supply. According to the report forecasts, the interest rate bond issues in the year may exceed RMB21 trillion, higher than the 2021 issue size of close to RMB20 trillion. Based on the estimated ceiling, the annual CGB issuance may reach RMB8.83 trillion, representing net financing of RMB2.76 trillion. The annual issuance of policy bank bonds may be RMB5.72 trillion, representing net financing of RMB2.21 trillion. The annual issuance of local government bonds may amount to RMB7.4 trillion, with new issuance estimated to RMB4.95 trillion and refinancing RMB2.4 trillion, if only the new bonds and the refinancing bonds earmarked for repaying matured bonds are considered.

The report predicts that, taking into account the economic fundamentals, overseas environment and other factors, the yield is very likely to move downward in 2022, and the turning point is expected to emerge in mid-year. The domestic economic development still faces the triple pressure of “demand contraction, supply shock and weaker expectations” in 2022. Economic growth is likely to slow down with the monetary policy easing marginally, possibly driving the yield down. With macro policies working gradually to stabilize growth, economic recovery may improve marginally in the second half of 2022, coupled with a high probability of the Federal Reserve’s rate hike in mid-year or so. Thus the yield of China Government Bond is expected to move higher. The annual yield movements may be roughly divided into three stages in 2022: bumpy upturn, bumpy downturn and overall upturn. The annual low may appear around the middle of the year, with reference to the yield of 10-year China Government Bonds touching a low of about 2.5% during the pandemic and the yield decline to a range of 2.75% to 2.8% after the two RRR cuts in 2021. The report forecasts that the yield may bottom at around 2.7% with the policy rate remaining unchanged. In a persistent push for market-oriented reform, China has guided the market interest rate to move reasonably around the policy rate in recent years. Under this background, the yield may be normally at a low volatility level. Considering the annual yield range in recent years, the yield of 10-year China Government Bonds may move within a range of 40 to 50 bps in 2022. Given a low of 2.7%, it is likely to see a high of 3.1-3.2%, and the annual yield curve may be N-shaped.

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