RRR Cut in H2 2022 Expected to Drive 10-year CGB Yield up Slightly to Around 2.9%

Hong Kong, 29 August 2022 -- The Research Institute of China Chengxin International Credit Rating Co., Ltd. (hereinafter referred to as "the CCXI Research Institute") recently released a report titled "Bond Yield May Rise Slightly to 2.9% as Funding Prices Fall Across the Board Amid Monetary Easing: H2 2022 Outlook for Monetary Policy and Interest Rate Bonds. According to the report, the monetary policy in the second half of the year is expected to adhere to the "China-centric" approach, with stability at the forefront. To address the structural problems in economic operation, the People's Bank of China ("PBOC") will continue to use re-loans and direct tools to support the weak aspects and key areas in a targeted manner. Meanwhile, it will also launch reserve requirement ratio (RRR) cuts in due course depending on the economic recovery. In this context, **the bond yields in the second half of the year will go up slightly, of which the 10-year Chinese government bond (CGB) yield may continue to fluctuate around 2.9% within a narrow bond.**

The report sums up China's monetary policy and operation of its interest rate bond market in the first half of 2022 into the following three characteristics. First, benefiting from the steadily loose monetary policy, the across-the-board fall in funding prices lowered interest rates, and open market operation marginally tightened in the second quarter. In the first half of the year, the PBOC announced one interest rate cut, one across-the-board RRR cut, one 1-year loan prime rate (LPR) cut, and two 5-year LPR cuts. Besides, the central bank flexibly adjusted the rhythm of fund placement depending on liquidity pressures, of which open market operations marginally tightened in the second quarter due to the gradually increased funding supply. At the same time, the interest rates of funds went down, considering the ample interbank liquidity derived from the central bank's interest rate cut, across-the-board RRR cut, and other factors as well as the cut of standing lending facility (SLF) rates as corridor ceilings. **Second, for local government bonds (LGBs), the spike in trading volume drove up the total issuance volume, and interest rate bonds registered a year-on-year increase in issuance volume.** In the first half of the year, the explosive trading volumes of LGBs and CGBs pushed up their total issuance volumes, while the issued interest rate bonds hit RMB11.47 trillion, an increase of RMB2.28 trillion compared with the same period of last year. Specifically, LGBs increased significantly by RMB1.91 trillion to RMB5.25 trillion; CGBs gained RMB617.73 billion to RMB3.44 trillion; and policy-related financial bonds shrank by RMB246.39 billion to RMB2.78 trillion. **Third, risk aversion pushed up the trading volume, as a result of which yields moved down and fluctuated within a narrow band compared with the same period of the previous year.** In the first half of the year, the Russian-Ukrainian conflict, the COVID-19 flare-ups at home, and other factors fueled risk aversion among investors, with the trading volume of interest rate bonds surging by RMB14.08 trillion to RMB73.65 trillion compared with the same period of last year. Overall, interest rate bond yields fluctuated within a certain range. The 10-year CGB yield dropped by 38.60BP to 2.78% over the same period of a year earlier. Specifically, the yield was basically flat in the second quarter compared with the

first quarter.

Looking ahead to the year-round policy, the report believes that the economy may recover slowly in the second half of the year, and that the monetary policy will remain prudent, focusing on the fundamentals of the domestic economy and the effective combination of aggregate and structural tools. In the process of a slow economic recovery, which is likely to be "asymmetric W-shaped", the monetary policy will pursue the "China-centric" approach, with "stability" at the forefront, to keep underpinning the economic recovery in both aggregate and structural terms. When it comes to choosing monetary policy tools, re-loans and direct tools will be used as usual to provide targeted support for small and micro-sized enterprises, science, technology and innovation (STI), green development, and other areas. Meanwhile, the PBOC will also launch RRR cuts in due course depending on the economic recovery to ensure liquidity and reduce costs. In terms of the form and extent of an RRR cut, the report argues that the central bank may prefer an across-the-board RRR cut over a targeted one, considering that the difference in the money released by the two is relatively small yet the former can boost market confidence better. On the basis, the report further predicts that, in the context of the current ample interbank liquidity, a 25BP cut is very likely, which may release the money of RMB500 billion and drive liability costs of banks down by 2.2BP.

The report holds that there are still interest rate bonds of nearly RMB10 trillion to be issued in the second half of the year, which would mainly consist of policy-related financial bonds and CGBs. As almost all new special bonds were issued by the end of June, LGBs to be issued in the second half of the year may decrease significantly, of which refinancing bonds would make the bulk, with the issuance volume expected to cross the RMB1 trillion mark. Given the recent increase in policy-related loans worth RMB800 billion to support infrastructure construction, policy banks may need to step up fund-raising efforts on the liability front. Coupled with the announcement made at the June 30 Executive Meeting of the State Council that RMB300 billion of special construction bonds would be restarted to supplement the project capital, the issuance volume of policy-related financial bonds in the second half of the year would further increase, with over RMB3 trillion of such bonds to be issued. Along with the further increase in central government spending, the possibility of renewing special CGBs due during the year has further increased. Taking this factor into account, there would be more than RMB5 trillion of CGBs to be issued within the year. At the same time, we cannot rule out the chance that the recurrence of the pandemic, the weaker-than-expected economic performance, the intensified contradiction between fiscal revenues and expenditures will prompt the issuance of new special CGBs to supplement local financial resources.

As the report predicts, the yield movements in the second half of the year may be more dependent on the conditions at home, and the yields may go up slightly compared to the first half of the year against the backdrop of the reduced liquidity pressure and gradual economic recovery. At present, considering that China's bond market is currently quite tolerant of the yield spread between the Chinese and US government bonds, it is less likely that CGBs follow their US counterparts and move up sharply. In this case, the yield spread between the two countries may only provide some restraints at the bottom, and CGBs' yield movements will be more dependent on the conditions at home. From the liquidity perspective, the subsequent issuance of new special bonds brings relatively low supply pressures. Coupled with the expectation that the monetary policy wouldn't be tightened significantly, even if there are new

special CGBs issued, it is hardly possible to cause considerable disturbances to liquidity. China would continue to repair its economic fundamentals in the second half of the year, as the macro policies play their role in stabilizing growth more apparently. The fundamentals of the Chinese economy would marginally improve compared to the first half of the year, given the prediction that another massive shutdown of production, like that in April, would be less likely thanks to the ongoing pandemic control measures. Even so, the recovery of the Chinese economy will be slowed down by the inadequate market confidence, lingering cost pressure on enterprises, and other factors. Compared with the first half of 2022, the 10-year CGB yield may gain slightly to about 2.9% and continue fluctuating narrowly in the second half of 2022.

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中诚信国际信用评级有限责任公司

地址：北京市东城区朝阳门内大街
南竹竿胡同 2 号银河 SOHO6 号楼
邮编：100020

电话：(8610) 6642 8877

传真：(8610) 6642 6100

网址：http://www.ccxi.com.cn

China Chengxin International Credit Rating Co., Ltd

Address: Building 6, Galaxy SOHO,
No.2 Nanzhugan hutong, Chaoyangmennei Avenue,
Dongcheng district, Beijing, 100020

Tel: (8610) 6642 8877

Fax: (8610) 6642 6100

Website: http://www.ccxi.com.cn

中国诚信(亚太)信用评级有限公司

地址: 香港中环康乐广场 1 号
怡和大厦 19 楼 1904-1909 室

电话: (852) 2860 7111

传真: (852) 2868 0656

网址: http://www.ccxap.com

China Chengxin (Asia Pacific) Credit Ratings Company Limited

Address: Suites 1904-1909, 19/F, Jardine House,
1 Connaught Place, Central, Hong Kong

Tel: (852) 2860 7111

Fax: (852) 2868 0656

Website: http://www.ccxap.com