Highlights:

The PBoC published its second quarter monetary policy report last Friday. The PBoC downplayed the role of M2 due to its declining predictability and falling correlation with the real economy. This hinted that the central bank is unlikely to ease the monetary policy because of decelerating M2. Meanwhile, average funding costs continued to climb up in the second quarter. The loan quota constraint and higher funding cost are likely to cap the growth momentum in the second half. As such, our view for Chinese economy to decelerate in the second half remains unchanged.

The draft restructuring plan for debt troubled State owned Dongbei Special Steel has been approved by creditors last week. Although smaller creditors (owed less than CNY500K) will continue to enjoy the benefit of implicit guarantee, larger creditors will face 78% haircut should they choose debt repayment in cash than equity. This case caught market attention due to this company's SOE status. This is a wakeup call for investors to reassess China's credit risk.

On currency, we just witnessed a remarkable turnaround story. RMB not only appreciated strongly against the dollar by 0.8%, but against the currency basket by 1.25% as well. This is the largest single week gain of RMB index since China introduced the index in late 2015. The outperformance of RMB index showed that the recent RMB move is no longer only a dollar story, it is also partially attributable to changing sentiment. The correction of long dollar position is likely to add to short term momentum. As such, we think the probability for the USDCNY to test 6.6 in the near term cannot be ruled out.

In Hong Kong, focus remained on the fast move of the HKD. USDHKD spot rate rose for the ninth straight trading day to 7.8278 before HKMA announced its bill sale plan on last Wednesday. The new issuance of EFB is considered a signal that HKMA is mopping up liquidity in the system. A sharp rebound in 1-year HKD interest rate swap and 12-month USDHKD forward points also indicates market expectations that the interest rate differential might have peaked. Therefore, any sharp depreciation in the HKD will be unlikely in the near term. On economic data front, GDP growth (+3.8% yoy) in 2Q remained resilient due to buoyant exports of goods, robust performance of the housing market and strong domestic demand. However, GDP growth may decelerate in 2H due to a fading base effect, muted tourism, and an expected correction in housing markets. We expect GDP growth to mark 2.5% yoy in 2017.

Key Events and Market Talk

Facts	OCBC Opinions
▪ The draft restructuring plan for debt troubled State owned Dongbei Special Steel has been approved by creditors last week. ▪ The plan may mark another important milestone to eventually break so called implicit guarantee.	▪ Smaller creditors, which owed less than CNY500K, will continue to enjoy the benefit of implicit guarantee to get back full payment. However, for larger creditors with exposure more than CNY500K will face two options including debt for equity swap or only 22% debt repayment in cash. ▪ Dongbei Special Steel's status as SOE suggests that the eventual breakdown of implicit guarantee has spread from private owned companies to SOEs. This is a wakeup call for investors to reassess China's credit risk. We think it is good for long term sustainable development of China's debt market though it may create volatility in the near term.
▪ PBoC published its second quarter monetary policy report last Friday.	▪ A few highlights from the report as below: ▪ First, PBoC downplayed the role of M2 due to its declining predictability and falling correlation with the real economy. This hinted that the central bank is unlikely to ease the monetary policy because of decelerating M2 as they reckon the single digit growth could be the new normal for M2 growth. ▪ Second, average funding costs have gone up gradually in the second quarter signalling that banks start to raise interest rate due to rising uncertainty from the monetary policy. Average mortgage rate rose by 14bps in the second quarter to 4.69%. The loan quota constraint and higher funding cost are likely to cap the growth momentum in the second half. As such, our view for Chinese economy to decelerate in the second half remains unchanged. ▪ Third, on currency, the PBoC confirmed that the introduction

	of counter cyclical factor in May help correct the asymmetrical depreciation problem faced by RMB. The central bank also considered the new mechanism as transparent and rule based with little intervention.
▪ USDHKD spot rate rose for the ninth straight trading day from 7.8091 to 7.8278 on last Wednesday due to a wider gap between HKD rates and USD rates. However, when HKMA announced to increase exchange fund bills (EFB) issuance size by HKD 40 billion by end of August, it resulted in a short-covering rally in the HKD and pushed USDHKD spot rate down sharply to 7.8123.	▪ The additional issuance of EFB will simultaneously reduce the aggregate balance by the same amount as the issuance size. As such, it is always considered as HKMA's tool to mop up interbank liquidity. ▪ In fact, as USD/HKD spot rate was approaching 7.8295, the level seen in January 2016, speculators took profits gradually as they expected that the HKMA would take actions sooner or later. This is also the reason why the market reacted instantly to the announcement of the HKMA. As market frets that the HKMA will continue to soak up liquidity by issuing EFB, we expect that speculators to become more cautious. A sharp rebound in 1-year HKD interest rate swap and 12-month USDHKD forward points also indicates market expectations that the interest rate differential might have peaked. Therefore, any sharp depreciation in the HKD will be unlikely in the near term. ▪ However, we do not see much upside on the HKD. Even after the bill sale by the HKMA, aggregate balance will still remain ample at around HKD 220 billion. Therefore, we expect the narrowing of interest rate differential to be rather slow. Furthermore, the return of interest in CNH-denominated assets and rotation of equity investment back to mainland so far in August may also not bode well for HKD. As such, USD/HKD is likely to range bound in 7.81 – 7.83 in the near term.
▪ Hong Kong Exchange (HKEX) announced to suspend the pilot program of 5-Year MOF T-bond Futures after the contracts mature in December. This is due to a lack of clear requirement from and a close cooperation between regulatory authorities in Hong Kong and Mainland China.	▪ In fact, market appeared to have little interest in HKEX's 5-Year MOF T-bond Futures. The daily average contract volume in HKEX was merely 47 in July, much lower than the daily average contract volume of 11394 for the 5-Year MOF T-bond Futures traded in China Financial Futures Exchange during the same period. Despite that, HKEX plans to launch new RMB interest rate product next year, in order to meet the hedging demand associated with the investment in Mainland bond market via the Bond Connect. We expect HKEX to increase the variety of offshore RMB currency and interest rate products with a further opening up of onshore capital account via cross-border connect schemes.
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Key Economic News	
Facts	**OCBC Opinions**
▪ China's current account surplus widened to US$52.9 billion in 2Q from US$18.4 billion in 1Q. However, non-reserve capital and financial account returned to deficit of US$21.2 billion in 2Q after recording a surplus of US$36.8 billion in 1Q.	▪ The rebound of current account surplus in the second quarter was mainly the result of widening goods trade surplus, which spiked to US$133 billion due to stronger than expected export growth. However, current account surplus in the first half of 2017 fell by 35% yoy to US$71.3 billion due to widening service trade deficit despite stabilized goods trade balance. China's service trade deficit remained high of US$135 billion in the first half, close to record high of US$135.1 billion recorded in 2H 2016. Deficit from tourism was at US$115.8 billion, which accounted for 85.8% of total service trade deficit. As

	such, China's current account surplus as % of GDP fell to 1.3% in the first half of 2017. ▪ China's non-reserve financial account recorded a surplus of US$15.6 billion in the first half of 2017, significant improvement from a huge deficit of US$226 billion recorded in the same period of 2016. However, China has not given the detailed breakdown of its capital and financial account for the first half with the exception of direct investment. Although net foreign direct investment fell by 27.2% to US$54.5 billion in the first half, China's net overseas direct investment tumbled by 67.4% in the same period to only US$40.4 billion due to tightening capital control. ▪ Outflows from tourism has taken over overseas direct investment as the single largest outflow channel. Given China's capital control is unlikely to target surging demand for Chinese to travel to overseas, we think China's service deficit is likely to continue to widen in the coming years. Therefore, China's current account surplus as % of GDP is likely to stay below 2%.
▪ China's FX reserve rose to US$3.08 trillion in July.	▪ The recovery of FX reserve for the past few months was mainly the result of valuation effect due to weaker broad dollar. Nevertheless, this also shows China's capital flow has been largely balanced.
▪ Both China's export growth and import growth decelerated slightly to 7.2% yoy and 11% yoy in July from 11.3% and 17.2% in June.	▪ Export growth to US slipped back to single digit after four straight months' double-digit growth. However, export growth to EU remain resilient at 10.12% in July. ▪ China's trade surplus with US narrowed slightly to US$25.22 billion but remains high. ▪ China's demand for electronic integrated circuit remain strong growing by 17.86% yoy by value. This may suggest China's export in the coming months may remain resilient due to improving global outlook. However, China's demand for commodity start to soften with the imports of crude oil growth decelerated to 11.8% in July by both value and volume. Given the base effect of commodity prices start to fade, we think China's import growth may decelerate further.
▪ China's CPI decelerated to 1.4% in July while PPI remained intact at 5.5% yoy.	▪ Inflationary pressure is likely to remain muted in the second half. We expect CPI to rebound slightly in August to around 1.8% due to rising food prices due to seasonal effect. However, low base effect is likely to kick-in in September. As such, we expect the CPI to stay low in the third quarter. ▪ PPI still stayed high in August due to rising metal prices. However, we expect PPI to fall gradually in the coming months due to base effect.
▪ Macau's housing transactions retreated by 41.6% mom in June to 915 deals. Approved new residential mortgage loans dropped 15.5% mom to MOP 4.85 billion from May's 5.74 billion, the highest level since June 2014. Average housing price edged down by 18% mom to MOP 94,265 per square meters in June.	▪ Disappointing data prints out of the housing market reinforce that government's cooling measure from May has started to take effect. In addition, an expected increase in borrowing costs following Fed's rate hikes may suppress demand. On the supply front, housing completions rose significantly by 1809% yoy in 1H while housing starts grew by 8% yoy during the same period. Taken all together, the housing market is unlikely to show much upside in the near term. However, a stable labor market, a bullish stock market and the strong recovery in the crucial gaming sector will likely continue to underpin housing demand. This is also the reason why homebuyers remained enthusiastic about the latest new residential project launches. Furthermore, given ample liquidity, interest rates are

	expected to be adjusted at a slow pace and may not cause any notable corrections in the housing market. Adding on a low base effect, we believe that to average housing price to grow by 0% - 5% yoy in 2017.
▪ HK's economy expanded by 3.8% yoy in 2Q 2017, beating market expectations. The resilient growth was mainly attributed to further improvement in domestic consumption (+5.3% yoy, which is the fastest since 2Q 2015 amid a tight labor market and increased wealth effect), fixed investment (+8% yoy, which is the strongest growth since 4Q 2012 given the uptick in housing market momentum and pickup in corporate sentiment) and exports of goods (+5.6% yoy on the back of improved external demand). ▪	▪ Moving forward, we expect economic growth to decelerate gradually in the second half of this year due to four reasons. First, an expected correction in both the housing and the stock markets may reduce wealth effect and moderate the growth in private expenditure. Second, private investment in housing market may slow down as investor sentiment has been hit by cooling measures and prospects for higher rates and increasing supply. Third, inbound tourism may remain muted given an expected slowdown in China's growth in the second half of this year. Fourth, the low base effect is likely to fade away. Still, based on the rosy economic growth in the first half of this year, we revise our forecast on economic growth from 2.2% to 2.5% for 2017. However, a combination of robust global recovery, a solid labor market and fiscal stimulus could add upside risks to HK's growth. Government's latest real GDP growth forecast for 2017 is revised up from 2-3% to 3-4%.

RMB	
Facts	**OCBC Opinions**
▪ What a remarkable turnaround story for RMB! RMB not only appreciated strongly against the dollar (about 0.8%) but against the currency basket as well (about 1.25%).	▪ It is no longer the pure dollar story. The outperformance of RMB index, which recorded the strongest single week appreciation since China introduced the RMB index in late 2015, shows that the recent rally of RMB could also be attributable to changing sentiment in the onshore market in addition to weak dollar. The correction of long dollar position is likely to add to short term momentum. As such, we think the probability for the USDCNY to test 6.6 in the near term cannot be ruled out.

OCBC Greater China research

Tommy Xie
Xied@ocbc.com

Carie Li
Carierli@ocbcwh.com