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The cause of the current bond market turmoil?

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Highlights:

- **The unprecedented stability in China's interbank market since July 2015 has created the illusion among bond investors that wholesale funding will remain stable for long.**
- **The sharp decline of bond yields driven by leverage purchase created the concerns about the asset bubble.**
- **Regulators have shifted their focus to contain asset bubbles since 4Q after the economy showed signs of stability, which led to the PBoC engineered correction in bond market due to tighter liquidity.**
- **The collapse of bond prices finally exposed the counterparty risk after Sealand Security was reported to default on its bond transaction.**
- **In a uniquely bond market turmoil, the once under the table entrusted agreement (代持协议) is in the spotlight.**
- **The market turmoil we saw last week is no longer the result of liquidity crunch but the result of breakdown of trust.**
- **Banks are reluctant to lend to non-bank financial institutions.**
- **It may take some time to repair the trust. Therefore, we should still expect the volatility ahead. However, we doubted the crisis will develop into a full blow-up scenario as we believe China's policy makers still have enough ammunition to maintain liquidity relatively stable.**

The government-engineered correction in China's bond market has entered the crisis mode last week. It's time for us to recap what has happened in order to understand what might happen in the future.

The whole story started from March 2015. Since then, China's money market funding costs have fallen sharply. PBoC has kept its benchmark interbank repo rate stable after the bust of equity bubbles in June and July 2015. The interbank funding costs remained stable despite rising volatility in China's currency market following the 811 reform on RMB fixing mechanism.

The unprecedented stability in China's interbank market unaffected by PBoC's reluctance to cut reserve requirement ratio amid massive capital outflows created the illusion among bond investors that wholesale funding will remain stable. This fuelled the demand for China's bond market. 10-year government bond yield, for example, fell from 3.5% in mid-2015 to a low of 2.6% in August and October 2016.

Chart 1: Volatility of interbank funding costs spiked again

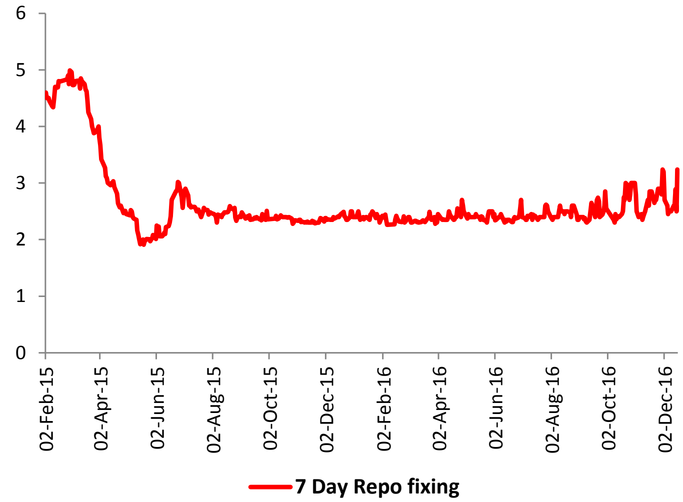
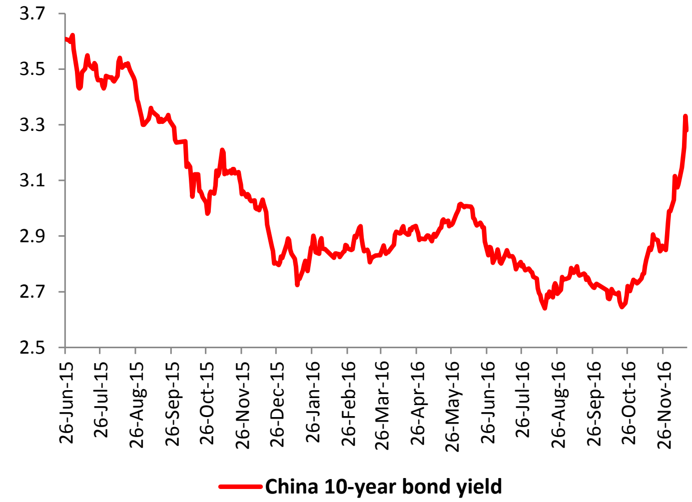


Chart 2: China's 10-year government bond yield



Source: Bloomberg, OCBC

With the sharp decline of bond yields, China's security companies have to increase their leverage for bond transaction in order to meet the guaranteed return to their investors, such as banks. Concern about the excess leverage has prompted regulators to warn the risk. However, market ignored the warning and continued to bet on the stable funding cost.

Since 3Q 2016, Chinese economy has shown signs of stability on the back of easing policy and booming property market. The improving economic outlook created the room for regulators to shift their focus to contain asset bubbles including property and bond bubbles.

Since 4Q 2016, PBoC started to replace its liquidity supply with more expensive medium term lending such as 6-month and 1-year MLF. As a result of tight bias monetary policy as well as concerns about further tightening measures, China's bond market has entered the correction phase since late October. The correction was further exaggerated by the reflation expectation following by Trump's victory.

The collapse of bond prices finally exposed the counterparty risk after Sealand Security was reported to default on its bond transaction. The company refused to bear the loss of bonds held by its counterparties via the so called entrusted holding agreement (代持协议) as the agreement may be involved in the fraud case by its ex-staff.

In a uniquely bond market turmoil, the once under the table entrusted agreement is in the spotlight. Market is still waiting for how the Sealand security is going to settle the dispute with its counterparties. Nevertheless, this incident has clearly dampened the market sentiment and broke the trust between banks and smaller non-bank financial institutions.

As such, the market turmoil we saw last week is no longer the result of liquidity crunch but the result of breakdown of trust. The spike of funding costs last Thursday was mainly due to big banks' reluctance to lend to non-bank financial institutions.

It may take some time to repair the trust. Therefore, we should still expect the volatility ahead. However, we doubted the crisis will further worsen as we believe China's policy makers still have enough ammunition to maintain liquidity relatively stable.

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