Summary

The meltdown in China's bond market and the Central Economic Working Conference are two biggest events for China last week. China's bond futures hit the circuit breaker last Thursday, first time since the inception in 2013, reminding the market painful experience of the burst of equity bubble in 2015. The collapse of bond prices has finally exposed the counterparty risk after Sealand Security was reported to default on its bond transaction. Clearly, this is no longer the issue of government-engineered liquidity crunch. Instead, the focus has been shifted to the breakdown of trust. 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. For readers who want to know what caused the current market turmoil in China's bond market, you may refer to details below, which we summarized based on timeline. The bottom line is that It may take some time to repair the trust. Therefore, we should still expect the volatility ahead. However, we doubted it will become a full blow-up event as we believe China's policy makers still have enough ammunition to maintain liquidity relatively stable.

We also shared our key takeaways for the latest Central Economic Working Conference below. Containing financial risk will be the key task for 2017 and the key policy shift may lie in monetary policy. The prudent and neutral monetary policy tone signals that monetary policy may move towards tight bias. Overall speaking, although we think the current meltdown in bond market is unlikely to lead to crisis, the overall funding costs for 2017 is unlikely to go back to the low level seen in 2016.

On currency front, the latest Central Economic Working Conference suggested to introduce higher currency volatility. This sent the USDCNY closing to above 6.96 on Friday. It seems that it is just matter of time that the USDCNY will test 7 should dollar continue its strength. The only bright spot is that RMB remain strong against its currency basket with the RMB index rose to 94.99 on Friday. Market will continue to digest the message from the meeting while waiting for settlement between Sealand Security and its counterparties.

Key Events and Market Talk	
Facts	**OCBC Opinions**
▪ The meltdown in China's bond market worsened last week with China's bond futures hit the circuit breaker on 15 Dec, first time since the inception in 2013, after Sealand Security was reported to default on its bond transactions. ▪ China's 10-year government bond yield surged further to end the week about 3.3%, up from 2.7% in early November. ▪ PBoC injected CNY394 billion liquidity via medium term lending facility last Friday to calm the market. In addition, PBoC also net injected CNY250 billion via its open market operation last week after net withdrawal of CNY535 billion in previous week.	▪ 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. ▪ With the sharp decline of bond yields, China's security companies have to increase their leverage when purchasing bonds 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 be 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 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 dampen 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 crisis 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.
▪ China concluded its Central Economic Working Conference on 16 December and set the guideline for next year.	▪ Below are our key takeaways ▪ First, flexibility will be the key tone. China will take a more flexible approach on growth target and currency volatility. China omitted the sentence "maintaining growth in a reasonable range". This shows that China is likely to drop its hard growth target, such as 6.5%-7% range for 2017. On currency front, the statement reiterated to keep RMB exchange rate basically stable at a reasonable level, however, it also said it will allow higher exchange rate volatility. This signals the higher tolerance for RMB depreciation should dollar continue to strengthen in the global market. Given China's FX reserve is likely to fall below US$3 trillion in the coming months, we think China may reduce currency intervention to allow market force to play a bigger role to digest the pent-up demand for dollar as a result of tightening control on capital outflows. ▪ Second, containing financial risk will be the key task for 2017. China has shifted its focus to contain financial risk since later part of 3Q after Chinese economy shows signs of stability. After burst of equity bubbles in 2015, liquidity has flooded to property and bond markets and recently into commodity market. This explains the recent tightening measures in both property and bond markets since 4Q. As long as growth prospect remains stable in 2017, we think Chinese government will continue to press market to de-leverage in both markets. ▪ Third, the key policy change may lie in monetary policy.

	Instead of previously prudent monetary policy, the new tone will be prudent and neutral for 2017. This sounds quite similar at a first glance. However, after reading between the lines, it clearly shows a tight bias monetary policy framework. There is no more mention about flexible policy and lowering the funding cost. Given 2017 is likely to kick off with higher inflationary expectation, relatively stabilizing growth prospect and concerns about asset bubbles, we expect monetary policy to remain tight bias. Overall speaking, although we think the current meltdown in bond market is unlikely to lead to crisis, the overall funding costs for 2017 is unlikely to go back to the low level seen in 2016. ▪ Last but not least, reform will be the key to solve the current puzzles. Four tasks for 2017 include 1) supply side reform including the ongoing de-capacity, de-leverage and de-stock; 2) supply side reform for agriculture sectors, 3) supporting the real economy such as those competitive manufacturing sector and 4) promoting the healthy development of property market, which may include land and tax reforms.
▪ Hong Kong: The volume of property transaction involving Double Stamp Duty (DSD) rose to its record high at 4995 and that involving Buyer Stamp Duty (BSD) also rose by 50% mom to 494 in November.	▪ Among the 4995 of transactions involving DSD, 52.8% was transaction of non-residential property, which jumped 44.5% mom to 2637. This clearly indicates that investment demand has shifted to non-residential property market, which as a result may continue to push up the prices of car-parking spaces and prime offices.
▪ Macau: Housing transaction volume edged up at its fastest pace since Nov 2012 by 140.5% yoy to 1022 units in October. In the same month, average housing price jumped 12.7% yoy to MOP89430/sq. m. while new mortgage loans approved rose further by 16.3% yoy to MOP2.87 billion.	▪ The rebound in gaming revenue shored up housing market sentiment further, which allowed the new residential projects to lure more home buyers. In the secondary market, even though sellers raised the asking prices amid market recovery, prospective buyers still showed huge interests. Looking ahead, the Fed's faster rate hike pace, tighter rules on junket operators, stagnant wage growth and cooling measures together signal that the recent pick-up in demand may be unsustainable. Combined with increasing supply, the stabilization of housing market may come to an end next year. Housing prices and transaction volume are expected to oscillate around their current levels in the coming quarter while we will see moderate downward risks over the rest of 2017.
▪ 3M HKD HIBOR rose for the 14th straight trading day to 0.95% last Friday, highest since 2009, further catching up with the LIBOR. USDHKD 3-month forward points also jumped to the positive territory for the first time since Feb.	▪ Adding on year-end effect and spill-over effect of tight liquidity in the onshore market, we expect the liquidity to remain tight and continue to drive up HIBOR in the near term. Though the Fed is seeing three rate hikes next year, the trajectory will still hinge on the impact of Trump's presidency and policies. At this juncture, we expect that gradual rate hike of the Fed and capital inflows from Mainland China will not push the HIBOR to surge too sharply. Also, the USD/HKD, which will succumb to upward pressure, may find strong resistance around 7.80 in the near term.

Key Economic News	
Facts	**OCBC Opinions**
▪ China's credit expansion remained strong in November. New Yuan loan increased by CNY794.6, up from CNY651.3 billion in October. Aggregate financing unexpectedly surged by CNY1.74 trillion,	▪ The strong credit data was still mainly driven by property market despite tightening measures. Medium to long term loan to household sector continued to grow at a strong pace of CNY569.2 billion, signalling the strong mortgage lending. In

up significantly from CNY896.3 billion in October. ▪ M1 grew by 22.7% yoy while M2 grew by 11.4%. The difference between M1 and M2 remains large though the gap has been narrowing.	addition, off balance sheet lending unexpectedly jumped. Both trust loan and entrusted loan increased by CNY162.5 billion and CNY199.4 billion respectively. The rebound of off-balance sheet lending may be due to tighter lending condition to developers following tightening measures, which driving developer's funding demand to off-balance sheet lending. ▪ The narrowing gap between M1 and M2 growth shows the improving sentiment. This is in line with recent re-acceleration of private fixed asset investment.
▪ China's forex purchase fell by CNY328.7 billion in November. ▪ The deficit in bank's sale and buy of foreign currency in November also widened to US$33.4 billion.	▪ Together with the further decline of FX reserve in November, all three data pointed towards the same direction that capital outflow continued in November.

RMB	
Facts	**OCBC Opinions**
▪ RMB continued to weaken against the dollar after the dollar index gained following the more hawkish than expected Fed rate hike forecast for 2017. The USDCNY fixing broke 6.95 on Friday and the spot USDCNY ended above 6.96 after the statement from the Central Economic Working Conference signals higher currency volatility for 2017. ▪ RMB index, however, strengthened last week ending the week at 94.99.	▪ The USDCNH has been traded below the USDCNY for the past few trading days due to increasing offshore RMB funding costs, which make shorting CNH very expensive. However, this failed to stop RMB from further depreciating. ▪ It seems it is just matter of time that the USDCNY will eventually test 7 in the near term should dollar keep its current strong tone. With January is approaching, the seasonal dollar demand may not be helpful to cap the upside for USDCNY. ▪ The statement from the Central Economic Working Conference about higher volatility for RMB is likely to weigh down the sentiment this week.

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