Highlights:

China's longer end money market rate continued to drift higher last week with the 1-year SHIBOR ended the week at 4.3544%. In contrast, short-end money market rates fell due to relatively flush liquidity. This led to steepened money market curve, which was probably due to two reasons including expectation on less tightening monetary policy and bank's behaviour to borrow long lend short. On monetary policy, PBoC has softened its tone via resuming open market operation as well as oral communication. Meanwhile, in its latest meeting on 25 May, PBoC also unexpectedly previewed that it plans to conduct MLF operation in June to ease market concerns about liquidity shortage ahead of quarter-end. The U-turn of PBoC attitude towards liquidity helped ease funding costs in the short end. However, it failed to fill the gap for the medium term liability and banks are paying up for the medium to long term liability to cover the shortage arising from the maturing of CDs due to tightening regulatory environment. Nevertheless, the higher longer end SHIBOR rate also raised the concerns that the higher funding costs may eventually be passed to end-consumers, which may slow down the growth outlook in the coming quarters.

In terms of credit rating, the shoe finally dropped. Moody's downgraded China's sovereign rating from Aa3 to A1 on worsening debt outlook after both Moody's and S&P downgraded China rating outlook in March 2016. The probability of rating downgrade by S&P cannot be ruled out following Moody's downgrade although Fitch reiterated to keep China's rating unchanged. Nevertheless, the impact on China related assets is limited. In the onshore market, it seems market does not care too much about the rating change while in the offshore market; the limited supply of China related assets as most are held by Chinese investors also leads to limited room for short-sellers to play. That leaves the battle field to RMB. However, last week was clearly a bad week for RMB bear as sudden spike of RMB spots and higher funding costs have led to short-covering. CNH HIBOR is likely to stay high in the near term.

In addition, the confirmation from China to fine-tune its RMB fixing mechanism for the second time in 2017 to add countercyclical factor shows China's stronger RMB bias when dollar weakens in the global market. We are cautious on shorting RMB aggressively amid dollar weakness. China is out on Monday and Tuesday due to rice dumpling festival.

Last but not least, Moody's also downgraded Hong Kong's ratings to Aa2 from Aa1 and revised the outlook to "Stable" from "Negative", following its downgrade of China's sovereign rating. The reason behind the downgrade is that Moody's believes that credit trends in China will continue to have a significant impact on Hong Kong's credit profile due to close and tightening economic, financial and political linkages with the mainland. We believe that the downgrade will have limited impact on Hong Kong issuers and investor sentiments as Aa2 stable is still a solid rating.

Key Events and Market Talk	
Facts	**OCBC Opinions**
▪ China's 1-year SHIBOR continued to drift higher, ending the week at 4.3544%, above 1-year benchmark lending rate. ▪ However, short end money market rate fell significantly due to flush liquidity. ▪ China resumed its daily open market operation last week to inject liquidity via 7-day and 14-day reverse repo.	▪ The pickup of longer end money market rates led to two interesting phenomenon. First, money market curve steepened. Second, the longer end money market rate and lending cost inverted. ▪ First, the steepening money market curve was probably due to two reasons including expectation on less tightening monetary policy and bank's behaviour to borrow long lend short. ▪ On monetary policy, PBoC has softened its tone via resuming open market operation as well as oral communication. Meanwhile, in its latest meeting on 25 May, PBoC also unexpectedly previewed that it plans to conduct MLF operation in June to ease market concerns about liquidity shortage ahead of quarter-end. The U-turn of PBoC attitude towards liquidity helped ease funding costs in the short end. However, it failed to fill the gap for the medium term liability and banks are paying up for the medium to long term liability to cover the shortage arising from the maturing of CDs due to tightening regulatory environment. ▪ In addition, market talk is that banks have prepared medium to long term liquidity for quarter-end MPA, which drove the longer end rates. In order to compensate longer end rates, banks are actively lending out in the shorter end, which led to steepening money market curve.

	▪ Second, the pickup of 1-year SHIBOR, which is above 1-year benchmark lending rate may increase concerns that the higher funding cost may eventually be passed to end-consumers due to higher correlation between longer end SHIBOR rate and effective loan rate. This may eventually slow down the growth.
▪ China announced to fine tune its daily fixing mechanism again, the second tweak in 2017. A new "countercyclical factor" will be added into the calculation of new fixing mechanism.	▪ Under the latest revision, the daily fixing will depend on three parameters including 4:30pm onshore USDCNY closing, the change of currency baskets as well as newly added countercyclical factor instead of previous two parameters. ▪ The announcement of mechanism adjustment was not a surprise to us as our daily fixing model has broken down since mid-May and market has already started to speculate the possible fixing regime shift. The inclusion of countercyclical factor explained the stronger bias of daily RMB fixing amid broad dollar weakness for the past two weeks. ▪ The inclusion of countercyclical factor can be considered as the second technical adjustment for fixing mechanism in 2017 after China shortened the calculation of the change of currency baskets to 15 hours from 24 hours in Feb. Both technical adjustments are designed to help reduce volatility in the daily fixing. ▪ So what is exact countercyclical factor? Frankly speaking, it may still take a few weeks for us to quantify the factor. However, for corporate treasurers or investors, we think there is no point to focus too much on those technical issues. Instead, we think the story behind could be more telling. ▪ Since 9 May, dollar has entered another round of correction due to unwind of Trump trade. However, the USDCNY spot has been stuck in the narrow range. As such, RMB index has fallen again to test the record low since launch of the index. This leads to concerns that expectation on RMB depreciation may build up again. The stronger RMB fixing with the help of countercyclical factor will help break the vicious cycle. ▪ We will elaborate more in a separate note about the impact. To conclude, we see a stronger RMB bias amid dollar weakness under the new fixing mechanism though the new regime make daily fixing forecast more unpredictable as compared to before.
▪ Moody's downgraded China's sovereign rating from Aa3 to A1 on worsening debt outlook. The outlook was revised to "Stable" from "Negative".	▪ The shoe finally dropped after both Moody's and S&P downgraded China's rating outlook to negative in March 2016 citing China's high leverage. The probability of rating downgrade by S&P cannot be ruled out following Moody's downgrade although Fitch reiterated to keep China's rating unchanged. ▪ As mentioned by China's former Finance Minister Lou Jiwei in March last year, China does not care about the rating by global rating agency. The impact on onshore RMB assets pricing is limited. The impact on offshore China related assets is also limited due to limited supply of those assets, which are mostly held by Chinese investors. ▪ Overall, we believe that China's credit risks could be well contained in the near term by the latest wave of new regulations for "de-leveraging". Therefore, China's debt concern is unlikely to be heightened by the downgrade.
▪ Moody's downgraded Hong Kong's ratings to Aa2 from Aa1 and revised the outlook to "Stable" from	▪ We believe that the downgrade will have limited impact on Hong Kong issuers and investor sentiments as Aa2 stable is still

"Negative", following its downgrade of China's sovereign rating. The reason behind the downgrade is that Moody's believes that credit trends in China will continue to have a significant impact on Hong Kong's credit profile due to close and tightening economic, financial and political linkages with the mainland.	a solid rating. For HK government, its funding costs will barely increase given its sizable fiscal reserve. The resilient economic fundamentals in HK are also likely to weather the impact of the downgrade. We noted that due to regulatory and monetary tightening in Mainland China, Mainland companies increasingly turned to offshore market for fund raising. Loans for use outside of HK registering double-digit annual growth for the second consecutive month March. However, as HKMA had guided the banking system to remain prudent in exposure to Chinese names, we believe that credit risks related to Mainland companies is well contained. Furthermore, China's crackdown on leverage means that debt risks would not heighten or hit HK's credit profile in the short to medium term.
▪ CNH HIBOR spiked last week with overnight HIBOR fixing rate went up to 7.7565% last Friday, highest since January.	▪ The tightening liquidity was probably due to unwind of short RMB position in the offshore market after RMB suddenly spiked following Moody's rating downgrade. China has shown the stronger bias towards RMB recently. We think this may contribute to volatility of funding costs in the offshore RMB market further.

Key Economic News	
Facts	**OCBC Opinions**
▪ HK's total exports continued to grow by 7.1% yoy in April due to improved external demand on the back of global recovery. The shipments to Asian countries, such as Mainland China (+4% yoy), Japan (+9.8%), India (+96.9% yoy) and Taiwan (+30% yoy), all sustained their solid growth. However, exports to the US retreated by 1.9% yoy.	▪ As Trump's government may find it difficult to carry out fiscal stimulus, the US economy may not be as strong as we previously expected. If this is the case, demand from the US would not expand at a fast pace and lend little support to HK's exports. On a positive note, the lowered possibility of a stronger HKD amid the muted greenback performance may ease some downward risks on exports. Therefore, resilience in exports is expected to remain intact. Elsewhere, imports edged up 7.3% yoy, in turn narrowing trade deficit further to HKD34.1 billion. As the upward pressure on commodity prices was shrugged off due to an expected decrease in China's demand, imports may increase at a slower pace. This signals that the trade deficit could improve further.
▪ Macau: The number of visitor arrivals increased further by 11% yoy in April. The number of visitors from Mainland China and South Korea continued to rise by 7.1% yoy and 48.7% yoy respectively, while that from Hong Kong jumped by 25.3% yoy after falling for two consecutive months.	▪ The significant and broad-based growth was due to the base effect resulting from the different timings of the Easter Holidays between this year and last year. We expect that the lingering political issues between Mainland China and South Korea as well as Taiwan will continue to prompt Mainland tourists to visit Macau and Hong Kong instead. Also, the effect of the Labor Day Holiday will help to sustain the strong performance of the tourism sector into May. Looking ahead, we are still worried that the limited choice of budget hotels and high transportation costs may deter some re-visitation. However, the lowered expectations of a stronger MOP may increase the attractiveness of Macau to visitors. All in all, we believe that the tourism sector could continue to recover gradually and moderately this year.
▪ Macau's retail sales value rose significantly by 12% yoy in 1Q amid a low base effect and improved tourism activities. Watches, clocks and jewelry (+23.2% yoy), adults' clothing (+10% yoy) as well as leather goods (18.6% yoy) showed notable growth in their sales value. All these categories also	▪ Lowered expectations of a stronger MOP, the persistent attractiveness of new hotels and China's stabilization have supported the tourism sector and tourist expenditure (+16.6% yoy in 1Q). Furthermore, due to the government's subsidy scheme for the elimination of two-stroke motorcycles, sales value and volume of motorcycles, parts and accessories

registered double-digit annual growth in their sales volume.	increased by 49.6% yoy and 43% yoy respectively. However, the sales value of motor vehicles (-7.8% yoy) and communication equipment (-6.1% yoy) dropped, which signals muted local spending on durable goods amid stagnant wage growth. Given the low base effect, we expect the annual growth of retail sales to accelerate and print around 20% in 2Q.

RMB	
Facts	**OCBC Opinions**
▪ RMB fixing's stronger bias remained last week before China officially announced to fine-tune its fixing mechanism on Friday. ▪ RMB index fell further tracking weaker dollar index. However, RMB index stabilized in the second half of last week after RMB spot suddenly spiked.	▪ It seems that China prefers a stronger RMB fixing to break the vicious cycle of RMB to slow down the decline of RMB index. The spike of RMB spot in both onshore and offshore market was probably in reaction to Moody's rating downgrade.

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