

### Highlights

China's incremental financial market opening and reform in the past few months as well as China's compromise and pledge to import more US goods failed to stop Trump Administration from escalating the trade tension. The trade war will officially kick off from 6 July should both sides fail to find last minute solutions. China's tit-for-tat retaliation is likely to be the reaction in the near term. However, in the medium term, we expect China to expedite its plan to boost its domestic demand via proactive fiscal policies to cut tax and increase expense.

On economy, China's growth lost the steam in May with key economic indicators decelerated by more than expected. Although China's property investment remains supportive, the sharp deceleration of infrastructure investment as a result of clampdown on PPP and structural deleverage is likely to further weigh down on growth outlook. The unexpected collapse of aggregate social financing shows that China's de-leverage is taking effect as the funding demand continued to be shifted from off-balance sheet to on-balance sheet.

Against the backdrop of rising default risk and slowing growth, PBoC did not follow the Fed to hike its reverse repo rate as widely expected. The pause may also fuel the expectation on reserve requirement ratio cut again. In addition, there is no urgency for China to maintain its favourable yield differential against the US as capital outflow and currency stability is no longer the key concern for China. We think a slightly weaker Yuan is probably better for China amid rising trade tension.

One of the positive news last week is that China's fiscal revenue growth remains strong, above nominal GDP growth. This will give China room to stimulate the economy and counter the impact of trade war via proactive fiscal policies.

On currency, the sharp depreciation of RMB on Friday is in line with script that RMB may weaken should China react strongly to the trade tension. In addition, the rebound of RMB index to 97.85 last Friday, close to 98, may also attract more RMB sellers as market expect 98 to be a strong resistance for RMB index.

**In Hong Kong**, following the FOMC, all eyes were on the commercial banks last Thursday as market expected to see the first prime rate hike since 2006. However, the banks refrained from taking any action once again. As a result, market speculates that the wide US-HK yield differential will persist for some time amid ample liquidity. This boosted carry trade activity and pushed down the HKD. However, HKD is expected to rebound soon as liquidity is poised to tighten on half-year end effect and mega IPO. It is reported that Xiao's IPO will start to lock up money from 25 June at the earliest. As long as USD/HKD spot rate refuses to test 7.85, HKMA may not buy any HKD in the near term. On the HKD rates front, the spread of three-month HIBOR on one-month HIBOR has narrowed from over 70bps to 34bps. We expect the spread to shrink further towards its historical average of 25bps. In other words, one-month HIBOR may rise from the current 1.67% to 1.7% or even higher in the near term. We think the possibility of banks lifting prime rate around end of June amid tighter liquidity cannot be ruled out. Should commercial banks insist to stay put in the near term, we still expect to see at least one prime rate hike by 25 bps this year. After mega IPOs get done in the third quarter, HIBOR is likely to come off. In contrast, further rate hikes by the Fed may push up LIBOR. As such, a wider US-HK yield differential may spur capital outflows, reduce aggregate balance and sustain the tight liquidity condition. In this case, commercial banks may have to take action.

Key Events and Market Talk	
Facts	OCBC Opinions
<ul style="list-style-type: none"> <li>PBoC did not follow the Fed to hike its reverse repo rate as widely expected on Thursday after the PBoC has hiked its money market rate for four times since 2017.</li> </ul>	<ul style="list-style-type: none"> <li>Back in March after the last money market rate hike, the PBoC has mentioned clearly that there is no guarantee that it will follow the Fed every time.</li> <li>The pause of rate hike against the backdrop of rising default risk signals two things to us. First, the PBoC is likely to return to neutral stance to safeguard the bottom line of no financial risk after the recent data show that structural de-leverage has taken effect. The pause may also fuel the expectation on reserve requirement ratio cut again, which may be supportive of market sentiment. Second, there is no urgency for China to maintain its favourable yield differential against the US as capital outflow and currency stability is no longer the key concern for China. We think China will continue to allow market to play a bigger role in foreign exchange market.</li> <li>We expect PBoC to use both MLF and RRR cut to strike the</li> </ul>

<ul style="list-style-type: none"> <li>▪ The Office of the United States Trade Representative (USTR) released a list of China imports subject to additional tariff as requested by President Trump. The first set US\$34 billion 818 types of Chinese imports will be taxed 25% additional tariff effective 6 July while the second set US\$16 billion Chinese imports will undergo further investigation and public hearing.</li> <li>▪ China announced the tit-for-tat retaliation at the same day. China will impose 25% additional tariff on US\$34 billion worth of 659 US imports ranging from agriculture, auto to seafood etc effective from 6 July while the tariff on rest of US\$16 billion products will depend on the US's policy development.</li> </ul>	<p>balance between financial stability and structural de-leverage.</p> <ul style="list-style-type: none"> <li>▪ China's incremental financial market opening and reform in the past few months as well as China's compromise and pledge to import more US goods in the coming years failed to stop Trump Administration from escalating the trade tension. The trade war will officially kick off from 6 July should both sides fail to find last minute solutions.</li> <li>▪ Although the initial US\$34 billion is unlikely to have material impact on both economies, it does pose the risks to the global recovery and sentiment. Trump Administration's target at China's "made in China 2025" showed that the current tension is no longer restricted to trade but more like a technology war. In addition, as the animal spirits in the US has been rallied by President Trump's unpredictable approach, the tension is likely to be dragged on for a longer time.</li> <li>▪ From China's perspective, China has demonstrated clearly that even though it may compromise to let ZTE back to business or pledge to buy more US products, it will not give up its bottom line to support its own high-tech industries. The tit-for-tat retaliation is likely to be the reaction in the near term. However, in the medium term, we expect China to expedite its plan to boost its domestic demand via proactive fiscal policies to cut tax and increase expense. On the positive note, the recent faster fiscal revenue growth is expected to provide some buffer to the potential trade war.</li> </ul>
<ul style="list-style-type: none"> <li>▪ China eased the rules for qualified financial institutional investor scheme. The 20% monthly cap for foreign investors to repatriate the money out will be removed. In addition, the lockup period will also be removed for investment principal. QFII investors will also be allowed to hedge their currency risk in the onshore market.</li> </ul>	<ul style="list-style-type: none"> <li>▪ The ease of QFII rules is likely to further alleviate concerns about China's administrative costs. This will help attract more capital inflows into Chinese financial market, which is also in line with Chinese government's direction to further open its financial market.</li> </ul>
<ul style="list-style-type: none"> <li>▪ China's Ministry of Natural Resources said the unified national real estate registration system has been full operational.</li> </ul>	<ul style="list-style-type: none"> <li>▪ This could be the first step for China to move towards a transparent registration system, paving the way for China to eventually roll out the highly focused property tax. Although it may not have direct impact on property market.</li> </ul>
<ul style="list-style-type: none"> <li>▪ According to Charles Li, the Chief Executive of Hong Kong Exchanges and Clearing Limited (HKEX), the average daily turnover of Bond Connect reached RMB 3.1 billion and RMB 3.02 billion respectively in April and May, an increase of 17% and 13% respectively from the first quarter.</li> </ul>	<ul style="list-style-type: none"> <li>▪ Besides, foreign investors have held a total of RMB 1.375 trillion of Chinese bonds in the interbank bond market. This represents an increase of 63% from July 2017 when the Bond Connect was launched. As for Bond Connect, the number of participants also increased by 68 to 315 from end of 2017 to end of May 2018. Moving forward, the continuous inflows under capital account may help to offset some outflows under the current account, in turn sustaining the two-way volatility of the RMB. If Chinese taxation becomes more favorable and the diversified and effective hedging tools becomes more accessible to foreign investors, we may see further increase in capital inflows to onshore market.</li> </ul>
<ul style="list-style-type: none"> <li>▪ The HKMA followed the Fed's step to raise the base rate by 25bps to 2.25%. However, larger banks with sizeable deposit base are still not in a rush to take any action.</li> </ul>	<ul style="list-style-type: none"> <li>▪ In fact, in the interbank market, larger banks tend to be the lenders while small to medium banks are the borrowers. As such, the continuous uptrend in HIBOR is favorable to larger banks. In contrast, with one-month HIBOR moving up by more than 60bps since end of May, small to medium banks are bearing higher funding costs, which erode their mortgage profits. Specifically, HIBOR-based mortgage plan's floating rate which is set as one-month HIBOR plus 1.28% already reached 2.95%. However, With the prime cap, commercial banks only charge</li> </ul>

	<p>borrowers with prime minus 3.1%, namely 2.15%.</p> <ul style="list-style-type: none"> <li>▪ In the coming months, we expect liquidity condition to remain tight amid short-term factors, including dividend payment flows, half-year end and mega IPOs. As such, one-month HIBOR may rise from the current 1.67% to 1.7% or even higher in the near term, in turn narrowing its gap with three-month HIBOR to the historical average of 25bps. The possibility of banks lifting prime rate around end of June amid tighter liquidity cannot be ruled out.</li> <li>▪ Should commercial banks insist to stay put in the near term, we may wait till the fourth quarter to finally see a prime rate hike by 25bps. After a raft of mega IPOs get done in the third quarter, HIBOR is likely to come off. In contrast, LIBOR may rise after the Fed's possible rate hike in September. As a result, US-HK yield differential could widen and encourage carry trade. In this case, aggregate balance will likely fall below the crucial level of HK\$100 billion. On the other hand, rising inflation may prompt more central banks to tighten their monetary policy and trigger capital flight from HK. All in all, once capital outflows surge and cause the tight liquidity condition to persist, commercial banks may have to take action. We expect to see at least one prime rate hike this year.</li> </ul>
<ul style="list-style-type: none"> <li>▪ Meituan-Dianping, a Chinese online platform for local life services, is reportedly planning to file for an IPO in HK this month at the earliest. The company may aim to raise about US\$6 billion via the IPO.</li> </ul>	<ul style="list-style-type: none"> <li>▪ Following the revamp of IPO rules, Chinese companies have been increasingly keen to get listed in Hong Kong. This is reinforced further as HK stock market proved to be resilient despite higher USD rates and global uncertainties. Xiaomi's IPO is reported to start to lock up money on 25 June at the earliest. Though mega IPOs could freeze huge amount of money and lead to surge in HIBOR, the tightening of liquidity is noting but temporary. However, the listed companies may repatriate IPO proceeds out of HK. This could weaken the HKD and drive up HIBOR if the listed companies fail to attract new inflows to offset the repatriation of IPO proceeds. Net flows from HK to China under the two stock connects have seen outflows for three consecutive months which averaged over RMB 35 billion for each month.</li> </ul>

### Key Economic News

Facts	OCBC Opinions
<ul style="list-style-type: none"> <li>▪ China's aggregate social financing unexpectedly collapsed to CNY760.8 billion in May although new Yuan loan is largely in line with market expectation increasing by CNY1.15 trillion.</li> <li>▪ As a result, the growth rate of outstanding aggregate social financing decelerated further to 10.3%, lowest since 2005.</li> </ul>	<ul style="list-style-type: none"> <li>▪ The unexpected collapse of aggregate social financing shows that China's de-leverage is taking effect as the funding demand continued to be shifted from off-balance sheet to on-balance sheet. The traditional off-balance sheet channels including entrusted loan, trust loan and banker's acceptance shrank by CNY421.5 billion in May due to de-leverage, largest decline in record.</li> <li>▪ In addition, net bond financing also unexpectedly fell by CNY43.4 billion, first decline since June 2017. This is probably due to falling demand for credit bonds as a result of rising default risks.</li> <li>▪ Loan structure remains stable with medium to long term loan to both corporates and household increased by CNY795.4 billion, down slightly from CNY821.1 billion in April. As credit demand continued to shift to on-balance sheet, it was reported by onshore media that China has granted more unofficial quota to onshore banks to meet funding demand, though it was subsequently denied by the officials.</li> </ul>

<ul style="list-style-type: none"> <li>China's growth lost the steam in May with key economic indicators decelerated by more than expected.</li> <li>Industrial production slowed slightly to 6.8% in May, down from 7% in April.</li> <li>However, both fixed asset investment and retail sales decelerated at more than expected pace.</li> </ul>	<ul style="list-style-type: none"> <li>Production growth remains steady in line with the rosy picture painted by PMIs. Despite the noise from trade tension, as of now, China continued to benefit from the global recovery story.</li> <li>Nevertheless, investment and consumption started to disappoint. China's retail sales decelerated to 8.5% in May, down by 0.9% from April's reading, lowest since 2003. The weaker than expected retail sales was partially due to the decline of car sales ahead of proposed tariff cut in July.</li> <li>For investment, property investment was the only bright spot growing by 10.2% yoy in the first five months, up from 7% in 2017. Private investment slowed down slightly to 8.1% yoy in the first five months but still up from 6% in 2017. However the pace of deceleration of infrastructure investment remained notable as a result of clamping down on PPP and tightening on local government financing. The recent structural de-leverage targeting at local government and SOEs is likely to further weigh down the growth prospect. As such, we expect 2Q GDP growth to slow to about 6.5%.</li> </ul>
<ul style="list-style-type: none"> <li>China's fiscal revenue growth decelerated slightly to 9.7% in May from 10% in April. However, for the first five months, fiscal revenue growth remained strong at 12.2%.</li> </ul>	<ul style="list-style-type: none"> <li>The fact that fiscal revenue growth has outpaced nominal GDP growth in the first few months was probably the result of higher PPI. As PPI has bottomed out in April, we think China's fiscal revenue growth may remain high. This will give China room to stimulate the economy and counter the impact of trade war via proactive fiscal policies.</li> </ul>
<ul style="list-style-type: none"> <li>China's forex purchase by central bank increased by CNY9.1 billion in May despite the decline of FX reserve.</li> </ul>	<ul style="list-style-type: none"> <li>The modest rebound of forex purchase by central bank showed that China's capital flow remained balanced in May and the decline of FX reserve was mainly the result of valuation effect.</li> </ul>
<ul style="list-style-type: none"> <li>Approved new mortgage loans (+18.5% yoy to MOP3.98 billion) saw double-digit annual growth for the second consecutive month in April. Due to supportive measure as well as positive salary prospects, housing demand and mortgage demand from local first-home buyers remained upbeat.</li> </ul>	<ul style="list-style-type: none"> <li>However, given the removal of exemption of vacant property tax and the increased stamp duty on second-home buyers, overall housing demand turned muted. As such, housing transaction volume has dropped for two months in a row and was down by 10% yoy to 973 deals in April. Notably, first-home buyers accounted for 82.9% of the total transactions. On the supply front, the control measures indirectly reduced supply in the secondary market. Also, new home launches were seldom in the past few months. Consequently, strong demand from first-home buyers pushed up average housing price by 6.9% yoy (3% mom) in April. Clearly, the housing market remains distorted by the new property control measures.</li> <li>Latest data shows that housing completions and housing starts tumbled 20% yoy and 89% yoy to 415 units and 338 units respectively over the first four months of this year. This indicates that housing supply will continue to grow at a slow pace. In the short to medium term, we expect housing prices to remain supported and housing transactions to stay subdued. Watch out for possible prime rate hike this year which could cap the upside for the housing markets.</li> </ul>

<b>RMB</b>	
<b>Facts</b>	<b>OCBC Opinions</b>
<ul style="list-style-type: none"> <li>The USDCNY broke 6.40 following the decline of Euro as a result of dovish ECB meeting.</li> </ul>	<ul style="list-style-type: none"> <li>The sharp depreciation of RMB on Friday is in line with script that RMB may weaken should China react strongly to the trade tension. In addition, the rebound of RMB index to 97.85, close to 98, may also attract more RMB sellers as market expect 98 to be</li> </ul>

	a strong resistance for RMB index.
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