Highlights

Risk sentiment improved last week on the back of rumoured central bank window guidance to support credit bonds and looser than expected drafted asset management rules for commercial banks issued by banking regulator. China's credit bond tightened 10-20 bps across the curve while commercial bank shares jumped driving the benchmark index higher on Friday.

With China's funding structure for real economy has entered an unchartered territory after the stock of China's off-balance sheet lending fell for the first time in record in June, the cost benefit analysis shows that the cost of further financial tightening could outweigh the benefit against the backdrop of rising default risks and uncertain global situation. The heated debate regarding the role of fiscal policy in supporting growth in the past week did not stop PBoC from easing further to take a pre-emptive measure to safeguard financial stability.

In addition to monetary policy, the regulatory environment also shows signs of easing with the looser than expected drafted asset management rules for commercial banks show regulator's flexibility to balance between de-leverage and stable growth against the backdrop of dramatic shift of funding structure and rising uncertainty in the global economy.

On currency, there is still no clear line of defence in the sand at the current range and China has given market more room to find the equilibrium level as the current cost benefit analysis shows that benefit of RMB depreciation could still outweigh cost amid US-China trade war. However, we think the risk to chase the USDCNY higher has increased for two reasons. First, the recent comments from Trump administration on currency manipulation as well as strong dollar may prompt RMB short sellers to take the profit. Second, the quick decline of RMB index to 93 zone may test PBoC's comfort zone for RMB depreciation. As mentioned by the SAFE spokesperson last week China will consider the use of counter cyclical measures to iron out the short term volatility.

In **Hong Kong,** one-month HIBOR moved up from 1.74% on 13 July to 1.87% on 20 July due to concerns about the upcoming liquidity draining events including month-end, China Tower IPO and dividend payout flows. Moving into the end of July, we expect one-month HIBOR and three-month HIBOR to test 2% and 2.1% respectively. Also, front-end liquidity is likely to get tighter, which may push USDHKD spot rate down slightly towards 7.840-7.845. We may see commercial banks lift HKD fixed-deposit rates again due to the uptrend of HIBOR. Elsewhere, Hong Kong Stock Exchange has agreed with Shenzhen and Shanghai stock exchanges to work towards the inclusion of dual-class stocks in the stock connect program. In fact, since the market started to position for A-share's inclusion into MSCI emerging market index and H-shares' valuation became less attractive, the monthly southbound net inflows have dropped notably from RMB39.9 billion for Jan 2017-Mar 2018 to RMB5.47 billion for Apr-Jun 2018. However, moderate rebound in southbound net inflows could be expected if WVR companies are allowed to be included into the stock connect scheme. Finally, Fitch Ratings Inc. pointed out that banks in HK are facing increasing risks related to Mainland-related businesses. China's deleveraging campaign has increased the financing difficulties of the private-owned enterprises (POEs). As such, the growth of loans to Mainland POEs accelerated from 21.8% yoy as of end-2017 to 22% yoy as of end-March 2018. As of end-March 2018, loans to Mainland POEs accounted for a record 25% of total Mainland-related lending which took up a record 46% of total loans and advances. All in all, banks should be wary of risks associated with the increasing exposure to Mainland-related businesses against the backdrop of slowing Chinese growth.

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<tr><td>▪ Onshore news reported that PBoC has instructed big banks via window guidance to increase their support to meet funding demand via loan and investment in credit bonds. Additional medium term lending facility will be granted to banks which expands their net lending via 1 to 1 matching ratio. In addition, similar matching ratio will be granted to banks investing in investment grade credit bonds. Meanwhile, more incentives with 2 to 1 MLF matching ratio will be given to banks investing in high yield credit bonds with credit rating at AA+ and below.
▪</td><td>▪ The widow guidance fuelled the debate in the market whether China is moving towards stealth QE as central bank's balance sheet is likely to balloon further due to the expansion of MLF. However, we think this is still different from QE as the central bank will not underwrite the risk of credit bonds.
▪ We think this innovative operation is pretty more close to the Long-term refinancing operation (LTRO) offered by the ECB post global financial crisis given the similarity that the central bank does not provide direct support bond targeted bond market. ECB's aim of LTRO is to maintain a cushion for banks holding illiquid assets amid credit squeeze while PBoC's window guidance aims to give bank liquidity support to hold risky debt amid widening credit spread.
▪ Different from ECB's LTRO, which the ECB applies a haircut to the collateral, PBoC's MLF operation is more generous albeit</td></tr>
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	shorter as there is no haircut. Instead, it is embedded with leverage function as high yield investors will get two times liquidity. ▪ With China's funding structure for real economy has entered an unchartered territory after the stock of China's off-balance sheet lending fell for the first time in record in June, the cost benefit analysis shows that the cost of further financial tightening could outweigh the benefit against the backdrop of rising default risks and uncertain global situation. ▪ Despite PBoC official has cautioned the effectiveness of monetary policy without the support from proactive fiscal policy, the latest move shows that PBoC will remain alerted to contain the potential risk.
▪ China's banking and insurance regulator (CBIRC) issued the drafted rules on asset management business by commercial banks to seek public opinion. The new rule will serve implementation guidance for commercial banks following the release of broad asset management rules covering the entire sector in April.	▪ The asset management rules issued in April was the overall guidance on the sector aiming to close the loopholes and keep the leverage and shadow banking in check. The latest draft rules from the CBIRC is the follow-up to regulate commercial banks' business practice in the asset management sector. ▪ Same as the master guideline, the deadline for commercial banks to comply with the new asset management will be extended to the end of 2020. However, the new rule is less tight than previously speculated as publicly raised funds are still allowed to invest in certain non-standard assets such as trust loans and entrust loans though it will be subject to conditions such as duration matching and quota limits etc. ▪ In addition, commercial banks are also allowed to issue existing funds to invest in new assets during the transition period to meet the funding demands of the real economy though the new funds need to comply with the deadline. ▪ The latest drafted asset management rules for commercial banks fuelled the rally of banking shares last Friday as the less tight than expected rules show regulator's flexibility to balance between de-leverage and stable growth against the backdrop of dramatic shift of funding structure and rising uncertainty in the global economy.
▪ China's Commerce Ministry spokesman said in its regular weekly briefing that China will be forced and have to react to additional tariff on US$200 billion though he does not give details after being asked by two journalists.	▪ We doubt China will continue the tit-for-tat retaliation strategy against the backdrop of increasing domestic pressure as a result of rising default risks and slowing growth momentum. As such, we reiterate our previous call that risk of escalation of trade war may diminish in the near term.
▪ The SAFE spokesperson said in its press conference that China will use counter cyclical measures to iron out the short term volatility in the currency market to safeguard the financial system and maintain a balanced BoP.	▪ This is a timely reminder to the market China has tools in the toolbox to slow down the pace of RMB depreciation should market push the USDCNY higher too aggressively.
▪ The HKD moved towards the weak-end of the peg due to RMB's sharp depreciation, the greenback's broad strength and the news that China Tower IPO is postponed until the second week of August.	▪ Latest news confirmed that China Tower IPO will start to lock up liquidity on 25 July. Due to concerns about the upcoming liquidity draining events including month-end, China Tower IPO and dividend payout flows, longer-end (no less than one month) liquidity continued to tighten. Therefore, one-month HIBOR and three-month HIBOR moved up from 1.74% and 2% on 13 July to 1.87% and 2.075% on 20 July respectively. Amid fret about tight liquidity ahead, short HKD traders have remained cautious. This helps to explain why USDHKD did not touch 7.85 over the past few weeks. Moving into the end of July, we expect one-month HIBOR and three-month HIBOR to test 2% and 2.1% respectively. Also, front-end liquidity is likely to get tighter, which may push

	USDHKD spot rate down slightly towards 7.840-7.845. Elsewhere, we may see commercial banks lift HKD fixed-deposit rates again due to the uptrend of HIBOR.
▪ Over the last weekend, Shenzhen and Shanghai stock exchanges announced to exclude the dual-class shares from the stock connect program as Mainland investors may not be familiar with the dual-class share scheme.	▪ Good news is that Hong Kong Stock Exchange has agreed with Shenzhen and Shanghai stock exchanges to work towards the inclusion of dual-class stocks in the stock connect program. Also, they reached a consensus in three areas. First, they reckon that enhancement and improvement in the stock connect scheme is needed to grow and develop the scheme in a stable manner over time. Second, they agreed that Mainland investors are not so familiar with weighted voting right (WVR) companies. For these companies to be included in the stock connect scheme, an initial Special Stability Trading Period will be required, on top of the current stock connect rules. Third, the three stock exchanges have reached a consensus to set up a joint working group to formulate the specific programs and supplementary rules for the inclusion of WVR companies. ▪ In fact, since the market started to position for A-share's inclusion into MSCI emerging market index, the monthly southbound net inflows have dropped notably from RMB39.9 billion for Jan 2017-Mar 2018 to RMB5.47 billion for Apr-Jun 2018. In contrast, during the same period, the monthly northbound net inflows increased from RMB18.8 billion to RMB42.3 billion. With HK stock market surging over 50% from 2016's trough, H-shares' valuation has become less attractive than before. Hang Seng China AH premium index slid from 137.8 on 2 February to 118.3 on 19 July. With an increasing number of Mainland companies planning to get listed in HK, moderate rebound in southbound net inflows could be expected if WVR companies are allowed to be included into the stock connect scheme. However, it looks unlikely for southbound net inflows to outweigh northbound net inflows once again in the near term. Worse still, higher USD rates may fuel capital flight from emerging markets including HK. As such, continuous capital outflows will likely add downward pressure to the HKD and help elevate the HIBOR.
▪ Fitch Ratings Inc. pointed out that banks in HK are facing increasing risks related to Mainland-related businesses. As at the end of March, commercial banks' exposure to Mainland-related companies increased 14% yoy to HK$7.8 trillion.	▪ According to the data from HKMA, the growth of total Mainland-related lending decelerated to 15.8% yoy as at the end of March 2018 from 17.5% yoy as of end-2017. Due to high base effect, higher borrowing costs and looser liquidity in the onshore market, we expect total Mainland-related lending will increase at a slower pace throughout 2018. However, China's deleveraging campaign has increased the financing difficulties of the private-owned enterprises (POEs). As such, the funding demand of the POEs may gradually shift to HK. The growth of loans to Mainland POEs accelerated from 21.8% yoy as of end-2017 to 22% yoy as of end-March 2018. Furthermore, as of end-March 2018, loans to Mainland POEs accounted for a record 25% of total Mainland-related lending which took up a record 46% of total loans and advances. In this case, it is true that risks with regard to Mainland-related businesses are increasing across HK's banking system. ▪ In addition, the loans to building and construction, property development and investment combined with household debts represented 49% of total loans and advances. For smaller property developers, vacancy tax rate may weigh on their profitability. This will in turn add to higher interest rates in

	impairing the property developers' debt servicing capacity. All in all, commercial banks in HK may have to be wary of the risks associated with the increasing exposure to Mainland-related businesses and property developers against the backdrop of slowing Chinese growth and higher interest rates.

Key Economic News	
Facts	**OCBC Opinions**
▪ HK's jobless rate stayed unchanged at an over twenty-year low of 2.8% in 2Q18.	▪ The unemployment rate of tourism-related sector decreased further from 4% to 3.9%, amid the sustained revival of the tourism sector. As the exact impact of US-China trade conflicts on the real economy remains uncertain, the unemployment rate of trade sector reduced to 2.2% (lowest since 1998) from 2.3%. Elsewhere, with some signs of stabilization in the financial market, the jobless rate of financial sector decreased from 2.3% to 2.2%. Any further improvement in inbound tourism and benign economic growth will likely help to sustain the tight labor market. However, we are wary that possible slowdown in trading and financial activities amid trade war concerns will dent the hiring sentiments in the relevant sectors. Therefore, we hold onto our view that the unemployment rate may creep up slightly towards 3% in the second half of this year.

RMB	
Facts	**OCBC Opinions**
▪ Rmb depreciation accelerated again last week after the dollar index broke 95. The USDCNY broke 6.80 briefly before ending the week at around 6.78. ▪ RMB index weakened further to 93.77 on Friday, implying about RMB's 1.3% depreciation against its major trading partners year to date.	▪ The highly watched daily fixing remained largely in line with model prediction last week after the USDCNY broke the key psychological level of 6.7 in the second attempt. This signals that there is still no clear line of defence in the sand at the current range and China has given market more room to find the equilibrium level by themselves though the big banks were reported to continue to offer dollar liquidity to meet corporate hedging demand. ▪ Looking ahead, we think the risk to chase the USDCNY higher has increased for two reasons. First, the recent comments from Trump administration on currency manipulation as well as strong dollar may prompt RMB short sellers to take the profit. Second, the quick decline of RMB index to 93 zone may test PBoC's comfort zone for RMB depreciation. As mentioned by the SAFE spokesperson last week China will consider the use of counter cyclical measures to iron out the short term volatility.

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