Highlights

In China, the performance of sovereign debts and that of corporate/local government bonds diverged. After US President Trump stated his dissatisfaction with the recent announcement of trade war truce between US and China, risk-off sentiment was reignited. Trump's announcement of his plan to lift tariff on imported cars further sparked market concerns about trade war while his surprising decision to cancel the summit with North Korea's leader Kim Jong Un added to geopolitical risks. As a result, flows into safe-haven assets dragged down 10-year US treasury yield. This adds to the expected slowdown of China's economic growth in pushing down China's sovereign yield. China's 10-year sovereign debt futures ended the week at the highest level in more than one month. Moving forwards, whether there could be more upside for China's sovereign debt may partially hinge on the safe-haven demand. Lately, Trump changed his mind and will meet Kim Jong Un in Singapore as scheduled. Besides, U.S. Commerce Secretary Ross is scheduled to visit China during 2 Jun to 4 Jun to further discuss on trade relations with Vice President Liu He. We will see if these two events could help to ease concerns about trade war and geopolitical risks.

In contrast, corporate bond continued to take a hit as market fret about increasing default risks as a result of China's deleveraging effort. A unit of The privately-held CEFC China Energy said it will not be able to repay the RMB 2 billion bond. This heightens concerns about corporate default. Consequently, investors showed little interest in the newly issued bond of Beijing Orient Landscape & Environment. Similarly, risk premium on local government bonds rose notably. Last Friday, Hebei government auctioned 3-year bonds at a high yield of 3.6% while the newly issued 3-year bond of Guizhou government offered a higher yield of 3.76%. As a result, the credit spread on local government bond and that on corporate bond widened gradually.

With deleveraging campaign pushing up the funding costs of local governments and companies, infrastructure and private investment may continue to slow down and in turn weigh on the economic outlook. A muted economic outlook will then translate into stronger demand for sovereign bonds. Meanwhile, Chinese government bond could be supported by fears over the lingering trade tensions and geopolitical uncertainty. As such, credit spread looks set to widen further. Despite that, we believe that systematic risks are well contained at this juncture while the deleveraging efforts are paving way for a healthier and more sustainable economic growth in a longer term.

On the RMB front, the RMB followed the broad trend to depreciate against the USD and was barely affected by the news about US-China trade relations. RMB index also subsided from an over two-year high and fell to 97.63 after the PBOC set the USD/CNY fixing rate higher than expectations on 25 May. In the near term, the RMB may continue to be driven by the dollar factor. In the medium to longer term, an expected increase in capital inflows under capital account may help to cap the downside for the RMB.

In Hong Kong, USD/HKD moved down from 7.85 due to profit taking before month-end. This allows the HKMA to take a breather. After month-end, it is still possible for carry trade to return and push USD/HKD up to 7.85 once again. Nevertheless, short HKD traders are expected to be more cautious as HKD funding costs become more sensitive to short-term factors given a 39% decrease in aggregate balance since mid-April. Factors like quarter-end, Fed's possible June rate hike, mega IPOs and any further reduction in aggregate balance could bring one-month HIBOR to above 1.3% (the recent high) in the coming month. Therefore, we believe HKD will rebound after a brief retreat in early June. Meanwhile, we hold onto our view that higher funding costs will prompt banks to raise prime rate around mid-2018. However, the slow pace of local rate hikes may not crash the housing market. Recent new home launches saw huge oversubscription, indicating strong sentiment on the back of positive economic outlook and earnings prospects. On the supply side, housing completions and housing starts both fell substantially in 1Q18 as compared to the same period last year. The average waiting time for general applicants for public housing increased from 4.7 years to 5.1 years. The scarce public and private home supply will likely limit the downside for the housing market.

Key Events and Market Talk	
Facts	**OCBC Opinions**
▪ China's 10-year government bond future ended the week at a more than one-month high, mainly due to the increasing safe haven demand and expectations on China's economic slowdown.	▪ On the one hand, US President Trump said he is not satisfied with the recent talk between US and China and believes that an agreement between two countries is not easy to get done. This casts doubt on the two countries' trade war truce. In addition, Trump surprisingly cancelled the summit with North Korea's leader Kim Jong Un. Fret over the lingering trade tensions and geopolitical uncertainty triggered the return of risk-off sentiment. As a result, US 10-year treasury yield fell below 3%, followed by the rally in China's government bonds. On the other hand, the deleveraging efforts have translated into higher funding costs for

	companies and local governments. As a result, infrastructure investment and private investment are slowing down and are expected to weigh on the economic outlook. An expected moderation in China's growth therefore lends supports to the central government bond. ▪ Moving forwards, whether there could be more upside for China's sovereign debt may partially hinge on the safe-haven demand. We will closely monitor two important events in the coming weeks. First, during 2 Jun to 4 Jun, U.S. Commerce Secretary Ross is scheduled to visit China to further discuss on trade relations with Vice President Liu He. We will see if there could be any agreement being reached or any details coming out. Second, Trump changed his mind and will have the summit with North Korea' Kim Jong Un as scheduled. Whether this will have any implication for the trade talk between US and China also needs to be watched closely.
▪ A unit of The privately-held CEFC China Energy said it will not be able to repay the RMB 2 billion bond. This heightens concerns about corporate default as a result of China's deleveraging effort. Consequently, investors showed little interest in the newly issued bond of Beijing Orient Landscape & Environment. ▪ Similarly, risk premium on local government bonds rose notably. Last Friday, Hebei government auctioned 3-year bonds at a high yield of 3.6% while the newly issued 3-year bond of Guizhou government offered a higher yield of 3.76%.	▪ The lack of implicit government guarantee propels investors to ask for higher yields to compensate for higher credit risks. In addition, new rules for asset management have impeded private companies from financing via non-standardized assets and in the meantime shrank the demand for low-quality corporate bonds. As a result, the credit spread on local government bond and that on corporate bond widened gradually. ▪ With deleveraging campaign pushing up the funding costs of local governments and companies, infrastructure and private investment may continue to slow down and in turn weigh on the economic outlook. A muted economic outlook will then translate into stronger demand for sovereign bonds. Meanwhile, Chinese government bond could be supported by fears over the lingering trade tensions and geopolitical uncertainty. As such, credit spread looks set to widen further. ▪ For those local governments with weaker fiscal condition (such as overreliance on income from the decelerating housing market or overreliance on funds raised via PPP or Local Government Financing Vehicles) may find it costlier to raise funds and in turn result in a faster slowdown in local economic growth. In other words, given the structural deleveraging campaign, the divergence of economic growth across China could become more obvious in the short to medium term. ▪ In the meantime, private companies with weak profitability and high leverage could also take a harder hit. Despite that, we believe that systematic risks are well contained at this juncture while the deleveraging efforts are paving way for a healthier and more sustainable economic growth in a longer term.
▪ China's Finance Ministry announced to cut tariff on imported cars from 25% to 15%, starting July 1. The tariff on imported auto parts will also be reduced to 6% from the current levels of 8%-25%. Besides, China is said to consider encouraging private investment in state-owned automobile manufacturer.	▪ China reduced import tariffs on cars as promised while Trump administration considered increasing tariff on imported cars. Also, Trump administration launched a national security investigation into automobile imports. This indicates that US and China still have differences on trade issues. Therefore, until two countries reach a final agreement on the trade relations and more details come out, it is always too early to declare the end of trade war.
▪ The State Council unveiled the development plans for three Free Trade Zones (FTZ), including Fujian, Guangdong and Tianjin.	▪ For Guangdong FTZ, it will be a pilot zone for open economy, Guangdong-Hong Kong-Macau collaboration, Guangdong-Hong Kong-Macau services trade liberalization, and opening up of the financial industry. Guangdong FTZ will stress more on research

	and application of financial technology, block chain and big data. For Tianjin FTZ, it will focus on innovation of parallel import program for cars as well as the R&D, manufacturing, examination and application of Artificial Intelligence. Fujian FTZ will put priority on advanced manufacturing (including integrated circuit) and modern services (like cold chain logistics and healthcare). ▪ These development plans will support China's transformation from the world's manufacturing hub to an economy led by high-technology, advanced manufacturing and modern services. This will also pave the way for China's economy to rely less on external demand and to benefit more from the expanding internal demand.
▪ USD/HKD spot rate moved down from 7.85 as carry trade took profit before month-end effect materializes. As a result, the HKMA took a breather after buying a total of HK$19.02 billion during 15 May to 18 May. Aggregate balance stabilized at HK$109.45 billion. ▪ Due to month-end effect, front-end liquidity tightened with overnight, 1-week and 1-month HIBORs all edging higher.	▪ This week, we expect one-month HIBOR to surpass 1% and USD/HKD spot rate to stay well below the weak end of the peg. ▪ With month-end effect to abate in early June, USD/HKD spot rate could try to test 7.85 once again. However, short HKD traders are expected to be more cautious as aggregate balance has decreased by 39% since mid-April. From mid-June onwards, we will have FOMC meeting (14 June), quarter-end effect, mega IPOs and dividend payment flows. A combination of these liquidity draining events will likely push up funding costs and have several market implications. ▪ First, HIBOR may go up gradually after subsiding in early June. One-month HIBOR is expected to break 1.3% (the recent high) in the coming months. Second, we believe that USD/HKD spot rate will fall to around 7.84 after testing 7.85 in the first half of June. If this is the case, aggregate balance is unlikely to reduce radically but rather stabilize between HK$80-100 billion over the next two months. Third, banks may scramble for funds with higher fixed-deposit rates. We remain our view that banks would be prompted to raise prime rate around mid-2018.

Key Economic News	
Facts	**OCBC Opinions**
▪ China's industrial enterprise total profit growth accelerated to 15% yoy during the first four months of 2018 from 11.6% yoy in 1Q18. In April, industrial profit growth strengthened to 21.9% yoy from March's 3.1% yoy.	▪ April PPI growth accelerated to 3.4% yoy after slowing down for five consecutive months while the growth of purchasing price index stabilized. As such, faster growth of output price strengthened the industrial profits. ▪ Besides, the steel, chemical and automotive industries led the improvement in profit margins due to higher product prices, low base effect, faster production and lower costs. This indicates that the supply-side reform has made some progress. ▪ In addition, the impact of foreign exchange loss dissipated. Nevertheless, RMB continued to strengthen against the currency basket in May. This may have some renewed downward pressure on the industrial profits.
▪ In 1Q18, Hong Kong's housing completions and housing starts decreased notably by 72% yoy and 68% yoy to 1259 units and 2826 units respectively. ▪ The average waiting time for general applicants for public housing increased from 4.7 years to 5.1 years.	▪ This signals that the new home supply may not meet the government's target this year. The slowdown in housing starts indicates that the property developers may not want to increase the supply at a pace too fast to weigh down the housing prices. ▪ Due to the slow increase in new home supply and persistent undersupply of public housing, we expect downside for housing prices to be limited despite higher interest rate.

▪ Macau's total visitor arrivals increased for the third consecutive month by 8% yoy in Apr18. The number of overnight visitors rose for the 28th straight month by 9.3% yoy.	▪ Due to the different timing of Easter Holidays between this year and last year, the number of tourists from HK fell 12% yoy. Despite that, visitors from Mainland China, Taiwan and Japan increased by 16.5%yoy, 5.6% yoy and 7.6% yoy respectively. Besides, over 50% of the total visitors from Mainland (54%), Japan (63%) and South Korea (62%) stayed overnight. This reinforces our view that a new wave of mega projects openings has buoyed further improvement in the tourism sectors. ▪ Besides, the sustained growth of Asia and a weaker MOP against major currencies have boosted tourists purchase power and therefore boded well for the retail sector. A tight labor market and benign wage growth have also lent supports to the retail sector. As a result, retail sales jumped at the strongest pace since 4Q13 by 25.7% yoy in 1Q2018. Specifically, sales of watches, clocks & jewellery, which represented 21.1% of total retail sales, advanced 17.87% yoy. In addition, sales of goods in department stores, adults' clothing and leather goods accounted for 43% of total retail sales and climbed 33.8% yoy, 36.5% yoy and 37.1% yoy respectively. During the same period, the transaction volume and value of retail shops edged higher by 22.4% yoy and 84.4% yoy respectively in 1Q18. We expect the retail sector to sustain its strong growth tractions in the rest of 2018. This will in turn give a boost to the domestic economy.

RMB	
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▪ The USDCNY ended the week slightly higher, driven mainly by the dollar factor. RMB index also subsided from an over two-year high and fell to 97.63 after the PBOC set the USD/CNY fixing rate higher than expectations on 25 May.	▪ RMB followed the broad trend to depreciate against the USD and was barely affected by the news about US-China trade relations. In the near term, the RMB may continue to be driven by the dollar factor. In the medium to longer term, an expected increase in capital inflows under capital account may help to cap the downside for the RMB.

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