Summary
The focus shifted back to RMB last week after RMB entered a fresh round of depreciation against both dollar and basket currency, underperforming regional peers. PBoC was active last week trying to talk down RMB depreciation expectation, but market moved to in the other direction. RMB index ended the week down below 95 at 94.88 while the USDCNY spot broke above 6.65. Did last week's move indicated that PBoC says one thing but actually do another thing? We beg to differ. Instead, the divergence is the result of the fact that PBoC has been practicing its market-driven fixing mechanism strictly. The drawbacks of the current mechanical fixing system have been more obvious, which may have inadvertently trapped RMB in a gradual depreciation cycle. There are two major drawbacks include a ripple effect and cost of transparency. RMB's weakness tends to last longer after a big dollar shock under the current fixing mechanism. We did not see a clear way out of the current trap should dollar strength remain. As such, RMB may continue to drift lower.

The latest PMI data showed that it may be still too early to call for bottom for Chinese economy. We expect 2Q growth to slow down further to around 6.5% from 6.7% in 1Q. Despite heightening expectation on further monetary easing post Brexit event, China's central bank continued its wait-and-see approach. We still hold the same view that imminent interest rate cut is unlikely unless huge volatility in China's capital account re-emerge.

In the offshore market, the RMB liquidity is less drama at the end of June compared with end of March as the new RRR calculation method helped smooth out the liquidity fluctuation. However, the divergence between the implied yield from the swap market and cash market still told the story. CNH swap points in the short tenor moved to the left with the implied yield from swap market fell to negative again in the offshore market, however, unlike March, interbank cash rate remained positive. The divergence is likely to be the result of stronger dollar demand amid tighter dollar liquidity in both onshore and offshore market post Brexit.

For this week, market will look at G20 trade ministers meeting in Shanghai on 9-10 July. In addition, market will also turn to geopolitical risk as China announced to hold military drill in South China Sea ahead of Hague court ruling on 12 July.

Key Events and Market Talk	
Facts	**OCBC Opinions**
▪ PBoC published its 188-page long 2016 financial stability report covering banking, security and insurance sectors.	▪ In this report, the PBoC said asset quality in Chinese banking sector continued to deteriorate in 2015 with the non-performing loan ratio rose to 1.94% as of end 2015. Meanwhile, special mention loan ratio increased to 4.69% in 2015 from 3.99% in 2014. Loan provision ratio also fell by 50.86% to 181.18%. ▪ The report also warned the risk of rapid expansion of off-balance sheet lending, which rose by 24.48% yoy in 2015 to CNY82.36 trillion. ▪ Nevertheless, the latest stress test results showed that Chinese banks are able to weather the credit shock due to high capital buffer. Under the extreme situation when the NPL rose by 700%, the average capital adequacy ratio is expected to fall to 9.53% from current 13.32%, which is still in a comfortable zone.
▪ PBoC dismissed the media report that Shanghai suspended the foreign currency purchase by individuals.	▪ PBoC said there is no change on foreign currency purchase and overseas remittance for current-account purpose by individuals. ▪ However, Shanghai halted the foreign currency purchase by partnership companies for overseas direct investment financed by individuals as partnership company has been one of the informal channel for wealthy individual to move capital out of country, bypassing the US$50K annual quota.

	▪ In addition, local currency regulator also tightened surveillance on investment projects above US$5 million. ▪ Although PBoC has reiterated the reform on two-way flows in its latest 2016 financial stability report, its seems that China will remain cautious in terms of managing capital outflows in particular after the Brexit event.
▪ PBoC published the statement in its website saying that China has no plan to devalue its currency to gain competitive advantage in reaction to media report that China will allow the USDCNY to go higher to 6.8. ▪ PBoC also threatened to take legal action on media publishing false information to mislead the public.	▪ The news caused the sudden decline of RMB against dollar on 30 June with the USDCNH spiked to 6.7 level from around 6.6650. ▪ Both CNH and CNY recovered most of losses shortly, triggering the speculation that PBoC may intervene the market. However, it was denied by PBoC next day. ▪ The report, though being denied by PBoC, tested how fragile the sentiment is.
▪ The head of China's economic planning agency NDRC said China will roll out more preferential policy to support private investment in the second half of the year.	▪ The deceleration of private investment growth has been the recent focus of the market. The latest survey by government shows that the slowdown in private investment was mainly attributable to factors such as overcapacity, caution over the economic slowdown, market access as well as unfair treatment by local governments. How efficient the local government to implement the policy holds the key.
▪ China's Ministry of Finance managed to sell RMB14 billion dim sum bond in Hong Kong.	▪ The heightening risk-off sentiment post-Brexit created a good window last week for China to sell its dim sum bond. The ministry also pledged to sell another RMB 14 billion in the 2H. This will add liquidity to the Hong Kong's dim sum bond market. ▪ Elsewhere, as a record amount of onshore bonds maturing in 2H, SOEs and local government financing vehicles may increasingly turn to offshore bond markets for financing or refinancing.
▪ Moody's downgraded the outlook of Hong Kong's banking sector for the next 12 to 18 months to "negative".	▪ Due to the closer interconnection with Mainland China, Hong Kong's banking system is expected to face pressure on asset quality and profitability. According to the HKMA, mainland-related loans accounted for 44% of total loan and advanced in March, while SOE-related loans took up 42% of the total mainland-related loans. Given that most Chinese SOEs are struggling with excessive capacity and facing increasing margin pressure, their default risks tilt to the upside. ▪ Hong Kong banking system's large exposure to Chinese names, as a result, pushed the classified loans ratio up from 0.46% in March 2015 to 0.78% in this March. In the aftermath of Brexit, the U.K.-based banks in Hong Kong may also face the risks of capital withdrawal. ▪ On a positive note, given that the Fed is likely to delay its rate hike schedule post-Brexit, the sagging housing market in Hong Kong is expected to take a more gradual correction. As such, asset quality of mortgage loans could be resilient. The expected moderate capital outflow from Hong Kong thanks to slower Fed rate hikes will also help to sustain the high liquidity in Hong Kong's banking system.

Key Economic News

Facts	**OCBC Opinions**

▪ China revised its 1Q balance of payment data, current account surplus fell to US$39.3 billion, lowest since 1Q2014 while capital and financial account deficit was revised up to only US$0.2 billion.	▪ The deficit in service trade widened to US$57.6 billion due to rising outbound tourists while surplus in goods trade narrowed to US$103.9 billion due to weaker external demand. ▪ Both direct investment and portfolio investment recorded deficit. Foreign direct investment under balance of payment fell to US$411 billion, lowest since 3Q2009 while overseas direct investment remained strong at US$57.4 billion, second highest in record. ▪ Under the portfolio investment, foreign investors net withdrew US$23 billion in 1Q from China's onshore bond market at the record high level. Nevertheless, given China unveiled the details on opening of onshore interbank bond market to offshore investors, we expect the deficit in portfolio investment is likely to be narrowed.
▪ China's total foreign debt fell to US$1.3645 trillion in 1Q 2016, down from US$1.4162 trillion in 4Q 2015.	▪ Short term foreign debt fell from US$822.3 billion to US$746 billion while long term foreign debt increased slightly to US$381 billion from US$371.3 billion. ▪ Corporate sectors continued to deleverage in external debt space. Foreign debt borrowed by banks and others fell to US$558.1 billion and US$379.9 billion from US$612 billion and US$427.2 billion respectively.
▪ China's official PMI fell marginally to 50 in June from 50.1 in May while Caixin PMI fell by more than expected to 48.6 from 49.2.	▪ Both domestic and external demand weakened with new orders and new export orders fell to 50.5 and 49.6 respectively from 50.7 and 50. ▪ Input price fell to 51.3 from 55.3, signalling the easing price pressure. This does not bode well for the PPI. ▪ The latest data shows that China is trying to search for the bottom.
▪ The decline in HK exports value narrowed significantly from 2.3% yoy to 0.1% yoy in May, reflecting further improvement in trading activities. Meanwhile, import value dipped by 4.3% yoy in May to HK$ 317.7 billion, falling for the 16th consecutive month. A visible trade deficit of HK$26.2 was recorded as a result.	▪ Exports to major markets rebounded as well, with total exports to Asia as a whole growing by 0.6% yoy, among which the value of exports to China increased by 0.9% yoy. By comparison, in the same month, growth in China's import from HK jumped 242.6% yoy after increasing 203.5% in previous month. The persistent mismatch in data prints continues to signal that the fake invoicing activities continued to support capital outflow from the onshore market. In the short term, the unexpected Brexit and the expected inclusion of KRW into CFETs RMB index are likely to push up the currency's volatility. As a result, the deepening angst of RMB depreciation may exacerbate trade data mismatch in coming months. Elsewhere, export to other main trading partners showed some weakness, with exports to US falling 6.1% yoy and those to UK dipping 13.4% yoy. It raises concerns that demand across the globe may be further dampened amid the heightened uncertainty of global recovery after Brexit. In this case, we expect trade growth of HK to remain sagging in the coming months.
▪ HK total retail sales continued to decline in May, down 8.4% yoy. Value of retail sales totalled HK$ 35.7 billion, falling for the 15th straight month on yearly basis.	▪ Data signals that the business environment remained dampened in the retail sector amid weak inbound tourism and subdued tourists spending. We expect dimmer economic outlook of HK and the rout in asset market following Brexit could continue to dent local consumption sentiment. ▪ HK retail sector witnessed broad-based year-on-year decline in many types of retail outlet. Decline in the luxury segment continued to pose a severe drag on HK retail sales. Value of sales of jewellery and watches contracted for the 20th straight month by 18.7% yoy in May, which was also the 9th

	consecutive double-digit contraction. Meanwhile, sales of consumer durable goods dipped notably by 22.2% yoy, while sales value of Clothing, Footwear and Related Products dropped by 5.8% yoy. In the near term, HK retail sector is likely to be constrained by weak inbound tourism activities amid Chinese economic downturn and external uncertainties, in turn weighing down employment in this sector. Gloomy prospect for Hong Kong's retail sector will as a result translate into more downward pressure on HK retail shop property market.
▪ Macau jobless rate was unchanged at 1.9% in May, indicating a strong labour market.	▪ However, the labor market is not strong on a broad basis. Due to Macau's government tightening of rules on the gaming sector and the diminishing marginal benefit of last year's hotel and casino openings, the gaming sector as well as the hotels, restaurant and similar activities showed decrease in employment. The increasing margin pressure on hotel operators amid fiercer competition (hotel guests grew at slower pace while hotel occupancy rate has dropped for the 18th straight month on yearly basis) is also to blame for the lower employment in the sector. Additionally, delays in the completion of new projects resulted in further layoffs in the construction sector. Elsewhere, employment in wholesale & retail trade sector showed its first monthly growth in the past 6 months. However, the prospect of a stronger MOP on the back of a stronger USD amid risk-off bias post-Brexit may result in further weakness in tourists' purchasing power, thereby hitting retail sales and the sector's employment. Despite that, new hotels and casinos scheduled to open in the coming 1-2 years are expected to bring more job opportunities. All in all, we expect the jobless rate to stabilize below 2.0% this year.

RMB	
Facts	**OCBC Opinions**
▪ PBoC said in its social media account that RMB remains stable against basket currency though weakening against the dollar. ▪ However, CFETs RMB index stabilized around 95.25 for four days post Brexit event but fell again to 95.02 on 30 June and 94.88 on 1 July. RMB fixing weakened to 6.6496 the next day after PBoC's statement and the USDCNY spot broke above 6.6500.	▪ It is not China's fault to lose defence of 6.60 handle. The incredible volatility in the wake of Brexit drove RMB together with other major currencies to be weaker against the dollar and Yen. From that perspective, RMB did not really underperform other currencies. ▪ PBoC was active this week trying to talk down RMB depreciation expectation, but market moved to in the other direction. The divergence is the result of the fact that PBoC has been practicing its new fixing mechanism strictly. ▪ The drawbacks of the current mechanical fixing system have been more obvious, which may have inadvertently trapped RMB in a gradual depreciation cycle.There are two major drawbacks include a ripple effect and cost of transparency. RMB's weakness tends to last longer after a big dollar shock under the current fixing mechanism. ▪ There are only two ways out of current trap including waiting for the dollar retreat and intervening in the closing price for USDCNY. ▪ RMB may continue to drift lower.

Liquidity	
Facts	**OCBC Opinions**
▪ PBoC continued to manage the liquidity via non-traditional policy tool in June, such as CNY108 billion net injection via MLF and CNY171.9 billion via PSL. ▪ In the offshore market, the RMB liquidity is less drama at the end of June compared with end of March as the new RRR calculation method helped smooth out the liquidity fluctuation. However, the divergence between the implied yield from the swap market and cash market still told the story.	▪ Despite heightening expectation on further monetary easing post Brexit event, China's central bank continued its wait-and-see approach. We still hold the same view that imminent interest rate cut is unlikely unless huge volatility in China's capital account re-emerge. ▪ CNH swap points in the short tenor moved to the left with the implied yield from swap market fell to negative again in the offshore market, however, unlike March, interbank cash rate remained positive. The divergence is likely to be the result of stronger dollar demand amid tighter dollar liquidity in both onshore and offshore market post Brexit.

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