Summary

Lately, a raft of rosy data out of the U.S. strengthened the greenback, pushing USDCNY up above the crucial level of 6.70 early last week. After that, the PBOC seemed to have intervened in the CNY's closing price at 16:30, in an effector to drive the closing price higher than the fixing price. Meanwhile, the PBOC might have played down the reference to the basket currencies. As a result, during last Tuesday to Thursday, the CNY fixing was set stronger than expectations, leading the RMB index up beyond 95.00. Stronger CNY fixing signals that the PBOC might intend to defend the Yuan at 6.70 against the greenback. Higher fixing rates also helped to manage market expectation on the Yuan with both CNY and CNH edging up gradually.

However, commercial banks' settlement and sales of foreign exchange continued to post deficits in June. The deficit widened from CNY67.7 billion in May to CNY116.1 billion. Meanwhile, the forward settlement and sales of foreign exchange printed deficits of CNY5.5 billion, compared with surplus of CNY8.6 billion in May. Moreover, non-financial outbound direct investment (ODI) increased by 58.7% yoy over 1H. Coupled with the deepened fall in funds outstanding for foreign exchange, concerns raise that capital outflow risks are still alive. On a positive note, Chinese authorities relaxed rules on foreign investors in the free trade zones. This may bring capital inflows. Furthermore, recent safe haven demand and expectations on broad-based easing boosted demand for high yield bonds. Adding that China has opened up the interbank bond market, onshore bond market has lured several consecutive weeks of capital inflows, which partially offset the outflows. This will help the PBOC manage market expectations.

During G20 summit held last weekend, the PBOC's Zhou stated that the Yuan remains basically stable against the basket currencies while market confidence on the Yuan has also improved. However, unless the USD retreats significantly, the PBOC is going to face higher difficulty in defending the Yuan. Also, if the central bank continues to adjust the fixing rate, the transparency of the fixing mechanism will be harmed. In the near term, the change in fixing rate will be in the spotlight.

Given the relatively loose market liquidity, the PBOC may continue to prefer non-conventional monetary tools to inject liquidity. As such, we see low probability of rate or RRR cuts in the near term. Over this week, eyes will be on FOMC rate decision. Before the impact of Brexit becomes clear, the Fed is unlikely to act in the upcoming meeting. However, the Fed's rhetoric on the country's economic outlook and its expectations on rate hikes will impact the USD and hint on whether the CNY faces further downward risks. Elsewhere, whether the BOJ is to expand stimulus as expected this week will impact the sustainability of the Japanese yen's weakness. This will also affect the RMB index.

Key Events and Market Talk	
Facts	**OCBC Opinions**
▪ The State Council announced to temporarily adjust the regulations on the free trade zones.	▪ As for businesses other than those specified in the negative list, a registration system will temporality replace the approval one for the setup of foreign companies in the free trade zones. Meanwhile, China would temporarily open up the steel mills and other industries for foreign investors to take controlling or total stakes in the free trade zones. Similar to the previous acts, China's authorities are striving to attract capital inflows, in order to partially offset the capital outflows resulted from angst of depreciation in the Yuan. Moreover, the new rules may help to deepen the development of free trade zones and lend momentum to the industries struggling with overcapacity.

▪ China regulators tightened the leverage of structured asset management plans which invest in fixed-income products.	▪ The size of the senior tranche of bonds should not exceed three times (previously ten times) that of the junior tranche. The China Securities Regulatory Commission's act points to the heightening concern about credit risks after a series of default events. The curb on bond investors' leverage may add downward risks to the bond market.
▪ The State Council announced to develop direct-financing and let some financial institutions properly and legally hold companies' equities on trial basis.	▪ Recent curb on off-balance sheet financing has taken effect and the deepening development of direct-financing would make the bond market a more important platform to raise funds. However, the heightening credit risks have resulted in a large amount of bond issuance cancellation. In this case, it is possible that the companies may continue to rely on bank loans or even be reluctant to borrow money due to high difficulty of financing and low return of investment. Elsewhere, market speculates that debt-to-equity swap trials may be back on the table though authorities played down the expectations. News also spread that Liaoning government is trying to convince central government to allow Dongbei Special Steel to swap 70% debts into equity. However, debt-to-equity swap, especially for companies suffering overcapacity, is unlikely to fully benefit the financial institutions. First, as shareholders, financial institutions are not experts in corporate management. Second, unlike bond holders, shareholders' return is not guaranteed on regular basis. Third, if the companies go bankruptcy, the shareholders are subordinate to bondholders and are almost always get nothing at the end.

Key Economic News	
Facts	**OCBC Opinions**
▪ Commercial banks' settlement and sales of foreign exchange for clients posted a deficit of CNY116.1 billion in June (vs CNY67.7bn in May). ▪ China Ministry of Commerce released that non-financial outbound direct investment (ODI) increased by 58.7% yoy to USD88.86 billion (CNY580.28 billion) over 1H 2016.	▪ In fact, the willingness of purchase of foreign exchange by clients decreased in June, seen from the fall the ratio of banks' sales of forex for clients to foreign-related payments via banks on behalf of clients to 50% in June from 53% in May and 57% in April, thanks to more stabilized expectations of the Yuan's movement. However, the impact of Brexit has yet to be priced in to the data prints. Therefore, do expect market's willingness of forex purchase to increase again in the coming months, albeit the upside is limited amid capital outflow controls. However, the forward settlement and sales of foreign exchange posted deficits of CNY5.5 billion, compared with surplus of CNY8.6 billion in May. Coupled with the continuous surge in ODI, concerns raise that capital outflow risks are still alive. As such, pressure on the Yuan may continue to tilt downwards.
▪ Unemployment in HK retail sale sector rose to five-year high of 5.4%.	▪ The seasonally adjusted unemployment rate of HK remained high at 3.4% in June and underemployment rate was unchanged at 1.4%. Unemployment rate in the retail sector edged up by 0.1% to five-year high of 5.4% in June, as business performance in retail sales remained clouded amid shrinking tourist expenditure. We expect the slowdown of China's economy, on-going anti-corruption campaign and strong HKD to continue to hit HK's tourism sector as well as retail sales sector. Unemployment rate in the trade and wholesale sector decreased slightly from 3.0% to 2.9%, still high amid tepid external demand. Weak trade activities also resulted in

	worsening unemployment in the warehousing sector and transportation sector. Looking ahead, corporate hiring sentiment may remain overshadowed given the slow-growing domestic economy and dimmer business performance. We expect that employment in the retail sector would continue to take a hit amid slackening inbound tourism while employment growth of the trade sector may also be constrained as effects from the Brexit spill over.
▪ HK private residential housing starts registered 833 units in May.	▪ Housing starts in the first five months was 26.41% higher than that of same period last year. Figure indicated that the housing supply in private sector could be on a solid growth pace over next two to three years. On the other hand, completion in May rose significantly to 2,441 units amid the accelerated pace of construction. Completion in the first five months also surged 42.68% yoy. Based on the average housing starts figures, average supply of private residential units during 2016 to 2018 is estimated at about 16,526 units, higher than the five-year average of around 11,397 units in 2010 to 2014. This reinforces our view that the increasing housing supply could add downward pressure to HK housing market in the longer term. For the year, however, we upgrade our forecast for the average property price growth from -20% to -10%, as housing demand should be underpinned by low borrowing costs especially on a slower rate hike pace by the Fed.
▪ Mass market segment gained MOP22.4 billion (43.4% of total revenue) in 2Q, rallying by 0.2% yoy after declining for six consecutive quarters.	▪ The continuous pick-up in the mass market segment was due to the increase in casual gamblers attracted by latest new hotel and casino openings. Overnight visitors increased for the 11th straight month by 13.9% yoy in June. However, the relatively low minimum bet amount has limited the profitability of the mass market segment, especially given that the government restricts the growth of gaming tables (-1.5% qoq despite increase in casinos). As such, even though a new string of casinos are to be opened in 2H, gambling tables are unlikely to increase. To make matter worse, the relentless anti-corruption campaign in China, Macau government's tighter scrutiny on junket operators, and stringent anti-money laundering rules continue to weigh heavily on the VIP market, with VIP revenue sliding for the ninth straight quarter. ▪ Moving forward, should the fresh wave of new projects be completed as scheduled in the 2H and reinforce Macau's appeal to tourists (inbound visitors rose by 4.9% yoy in June) and recreational gamblers, the impact of tighter scrutiny and a less supportive government may be partially offset. If such is the case, we expect that gaming revenue will drop by around 5% over 2016.

RMB	
Facts	**OCBC Opinions**
▪ The raising expectations on additional monetary easing given mixed Chinese economic data, coupled with the heightened geopolitical risks, pushed the CNY down beyond the crucial level of 6.70 against the greenback early last week.	▪ However, the stronger-than-expected fixing price set during last Tuesday to Thursday indicates that the PBOC might have intervened in the CNY's closing price at 16:30 and downplayed the reference to the basket currencies, in order to manage market expectations of the Yuan. Therefore, the RMB index rallied gradually to above 95.00. Probably, the PBOC is striving to defend the CNY at 6.70 against the USD. Major concern is that the USD is unlikely to retreat significantly in the near term given the rosy US economic data. As such, the Yuan will continue to face downward risks, adding difficulties of the PBOC to defend the Yuan.

Liquidity	
Facts	**OCBC Opinions**
▪ The PBOC rolled over CNY227 billion medium-term lending facility on July 18 ahead of CNY218.5 billion coming due in late July while will also sell CNY50bn of three-month treasury deposits on July 21.	▪ The PBOC's actions reinforce that the central bank prefers non-conventional tools over traditional ones to inject liquidity. In this case, we continue to see low probability of broad-based RRR cuts or interest rate reductions in the near term.

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