Highlights:

Investor sentiment has been recovering as the PBOC and authorities issued statements to calm the market. Also, the PBOC resumed open market operations on May 16th after rolling over MLF operation on May 12th. This reinforces that the PBOC has taken a backseat and shifted its priority to assisting the authorities in avoiding liquidity shock resulted from the crackdown on financial leverage. As a result, both stock market and bond market found some support after the panic selling.

On the other hand, the PBOC officially approved the launch of a bond connect between Hong Kong and the mainland, although the launch schedule has yet to be released. Given our expectations on a rebound in the bond market (please refer to our week-in-review report released on May 15th), capital flows into the onshore bond market is expected after the launch of bond connect. This may help improve the balance of payments position as expected by the PBOC and support China's inclusion in major global bond indexes. Adding on the easing concern over RMB risks and lower pressure of capital outflows, the PBOC may consider loosening the capital controls gradually.

Furthermore, the top level authorities stated their aim to promote the use of RMB as investment and funding currency for the "One Belt One Road" initiative. We expect the RMB internationalization to regain momentum in the medium term.

In the near term, RMB may remain stable but show little room for further appreciation. Despite a broadly weakening USD and a stronger-than-expected RMB fixing since May 12th, the RMB index retreated to its record low on May 19th. We noted that the tracking error between market estimates and the eventual mid-points increased recently. Should the greenback find little support in the near term, the RMB index may continue to face downward pressure given the resilient EUR and GBP.

Key Events and Market Talk

Facts	OCBC Opinions
▪ The PBOC resumed open market operations with a net injection of CNY160 billion in last week. More notably, the PBOC increased the weight of injection via 7-day repo and halted the 28-day repo operations.	▪ This added to the MLF operation by the PBOC on May 12th in helping to ease market concerns over the tighter liquidity. Over the previous weekend, the authorities pledged to carefully manage the pace of monetary and regulatory tightening to avoid liquidity shock. As a result, both stock and bond markets rebounded last week. Meanwhile, northbound net inflows under the two stock connects reached its record high at CNY 3.16 billion on 16th May. ▪ We expect the stock and bond markets to pick up its pace in the near term.
▪ The PBOC officially approved the launch of the bond connect between Hong Kong and Mainland China, although the launch schedule has yet to be released. In addition, the central bank specified that the bond connect will start with a northbound trade first and there will be no quota for the trade. Furthermore, only institutional investors will have the access to the bond connect at the start.	▪ Given low exposure of foreign institutional investors to the onshore bond market, we expect flows into China's bond market to increase via the bond connect between Hong Kong and Mainland China in the long term. This may support China's inclusion in major global bond indexes. ▪ In addition, the PBOC expects the new scheme to enhance Hong Kong's role as an international financial center and help to open up Mainland China's financial market further. Furthermore, the PBOC believes that the new scheme will likely improve the balance of payments position. Based on this, we expect that the central bank may loosen its capital controls gradually in the medium term.
▪ President Xi pledged to inject CNY100 billion into the Silk Road Fund and encourage financial institutions to expand their RMB offshore fund businesses, which is expected to amount to around CNY300 billion. ▪ Minister of the Ministry of Commence, Zhong Shan, estimated that over the next five years, China will import USD2 trillion of goods from the countries involved in the "One Belt One Road" (OBOR) initiative while overseas investments will exceed USD750 billion.	▪ The Deputy Governor of the PBOC, Yi Gang echoed Governor Zhou Xiaochuan's proposal which aims to increase the use of RMB as investment and funding currency for the OBOR Initiative. According to the Ministry of Commerce, ODI towards 45 countries involved in the OBOR plan amounted to USD3.98 billion from January to April. In the long term, we believe that the development of the OBOR plan will support the RMB internationalization which has slowed down amid the capital controls.

▪ New regulation requires banks to register at the China Banking Wealth Management Registration System to specify all the underlying assets and liabilities involved in their own investment plans or the investment plans of other financial institutions which are entrusted by the banks to manage the funds. Registration on a pro-rata basis is not allowed.	▪ In fact, the issuance of wealth management products among the banking system decreased by 14.7% mom in April. Also, April's financial data reinforces that off-balance-sheet financing have been reducing amid the crackdown on financial leverage. Therefore, the new regulation is expected to shrink shadow banking further.
▪ HKD marked its largest daily gain since February 2016 against the greenback on May 15th due to higher demand associated with capital inflows to Hong Kong's stock market. Net southbound capital flow under the two stock connects have remained above RMB2.5 billion since May 10th.	▪ Given the upbeats sentiment on the stock market rally across Europe and the US as well as continuous capital inflows from Mainland China, the Hang Seng Index closed at its highest level since July 2015 on May 15th. In the near term, a subdued greenback may allow the HKD to stabilize. However, speculation on interest rate differentials between the HKD and the USD is likely to drive the HKD down again in the medium term.
▪ On May 12th, the HKMA announced its plans to tighten lending to developers with effect from June 1st, in order to ease credit and moral hazard risks faced by banks. The financing cap on lending for land costs and for construction costs will be lowered to 40% (from 50%) and 80% (from 100%) respectively. The overall cap will also be reduced from 60% to 50% of the expected value of the completed properties. In addition, the HKMA increased risk weight for property developers with mortgage book to equity ratios of more than 5%. ▪ Furthermore, the HKMA announced on May 19th that all banks will lower loan-to-value ratio cap by 10 percentage points for residential mortgage loans involving borrowers with one or more pre-existing mortgage loans and those who earn incomes majorly outside HK.	▪ The new wave of cooling measures may dampen market sentiments and help to reduce the heightened credit risks faced by banks. Also, we expect China's slowdown and a moderate hike in prime rate late this year to slightly hit the housing market. ▪ On the supply front, housing completions started to pick up pace with total completions in March increasing significantly by 401.9% yoy after dipping for two consecutive months. Meanwhile, housing starts also rebounded by 53.8% yoy in March. Increasing supply together with cooling demand is likely to lead to housing market correction in 2H. ▪ Nevertheless, given 1) a bullish stock market, 2) a stable labor market and 3) the low borrowing costs even after a 25 bps increase in prime rate, housing correction is more likely to be moderate. Our forecast on overall housing price growth of 0%-5% for 2017 remains unchanged.

Key Economic News

Facts	OCBC Opinions
▪ China's retail sales (+10.7% yoy) and industrial production (+6.5% yoy) both grew at a slower pace in April. ▪ For the first four months, fixed asset investments increased by 8.9% yoy, missing expectations.	▪ Despite the acceleration of growth in property investment, both property construction and property completion grew at a slower rate during the first four months. The growth in property transaction volume and value has also moderated. To add on, 15 first-tier and major second-tier cities all showed deceleration of growth in their housing prices in April. We believe that the lagged impact of the housing cooling measures has manifested and calmed the housing frenzy. ▪ On the other hand, growth in private investments retreated to 6.9% yoy for the first four months, as compared to a 7.7% growth for Jan-Mar. ▪ All the disappointing economic data prints for April reinforce our view that China's growth has peaked in 1Q and will slow down from 2Q onwards amid the crackdown on financial leverage and the tightened policy in the property market.
▪ The PBOC's yuan forex positions declined at a slower pace by CNY42 billion in April (a decrease of CNY54.69 billion in March). ▪ Meanwhile, Chinese banks net sold US$14.9 billion foreign currency in April.	▪ Continuous decline in net foreign currency sales over the past three months means that the three consecutive months of rebound in FX reserve was mainly due to the valuation effect rather than capital inflows. However, according to the SAFE, households' purchase of foreign exchange dropped on both a

	yearly and monthly basis and reached its lowest level in nearly one and a half years in April. This reinforces that a combination of capital controls, a stable RMB outlook and muted USD performance have alleviated the pressure of capital outflows. ▪ Still, we expect the mild deficit of net foreign currency sales and the moderate decrease in the PBOC's yuan forex positions to persist in the coming months.
▪ HK's seasonally adjusted jobless rate remained unchanged at 3.2% in the three months through April, its lowest level since 2Q 2014.	▪ Due to the improved tourism activities (visitor arrivals rose by 3.7% yoy in 1Q), the unemployment rate of the retail, accommodation and food services industry held static at a relatively low level at 4.7%. ▪ On the other hand, the jobless rate in the financial sector (2.4%), construction sector (4.6%) and trade sector (3.2%) all increased. As housing constructions have been picking up pace and the government is increasing spending on infrastructure, we believe the unemployment rate of the construction sector will decrease gradually. Improved trading activities on global recovery are also likely to underpin the hiring sentiment in the trade sector. However, a likely housing market correction may increase the jobless rate in the financial sector while the launch of bond connect could bolster labor demand for the sector. ▪ In conclusion, the labor market is expected to remain stable. Nevertheless, downward pressure has yet to be removed given expected slowdown in China over 2H.

RMB	
Facts	**OCBC Opinions**
▪ RMB fixing has been lifted by more than expected since May 12th. Also, USDCNH had dropped for six consecutive days due to a weaker dollar as a result of mixed economic data out of the US and the lingering political risks in the US. ▪ However, RMB failed to outperform other major currencies. As such, the RMB index fell for the sixth straight trading day on May 19th to its lowest level since record.	▪ We noted that the tracking error between market estimates and the eventual mid-points increased recently. ▪ Besides, the continuous decline of RMB index indicates that the RMB is trapped in the familiar loop again that RMB remains stable against the currency basket when dollar strengthens but remains stable against dollar when dollar weakens. ▪ Should the greenback find little support in the near term, the RMB index may continue to face downward pressure given the resilient EUR and GBP.

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